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Pension Fund "Socialism"

PETER F. DRUCKER

The Undelivered Health System — *Paul Starr*

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"Affirmative Action" Reconsidered

Thomas Sowell

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Pension fund "socialism"

PETER F. DRUCKER

IF "socialism" is defined as "ownership of the means of production by the workers"—and this is the orthodox definition—then the United States is the most "socialist" country in the world. Through their pension funds, employees of American business own today at least 25 per cent of the equity capital of American business. The pension funds of the self-employed, of public employees, and of school and college teachers own at least another 10 per cent more, giving the workers of America ownership of more than one third of the equity capital of American business. Within another 10 years the pension funds inevitably will increase their holdings and will, by 1985 at the latest, own at least 50 per cent of the equity capital of American business. And all of this, of course, excludes personal ownership of stock by individual American workers—a small, but not negligible, percentage of the total.

But what is even more important from the point of view of traditional socialist theory, the large employee pension funds—those of the 1000 to 1300 largest companies plus the 35 industry-wide union-managed funds (e.g., that of the teamsters)—own a controlling in-

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terest in practically every single one of the "command positions" in the economy. These include the 1000 largest industrial corporations (which goes down to companies with sales well below $100,000,000—which, by today's standards, are at best "fair-sized" companies) and the 50 largest companies in each of the "non-industrial" groups—that is, in banking, insurance, retail, communications, and transportation.[1] Indeed, a larger sector of the American economy (outside of farming) today is owned by the American worker—through his investment agent, the pension fund—than Allende in Chile proposed to bring under government ownership to make Chile a "socialist country," than Castro's Cuba has actually nationalized, or than is nationalized in Yugoslavia or even Poland.

The United States, without consciously trying, has "socialized" the economy without "nationalizing" it. The United States still sees itself, and is seen elsewhere, as "capitalist." But if terms like "socialism" or "capitalism" have any meaning at all (which is doubtful), what the United States economic system actually has become is a version of "decentralized market socialism."

I. The pension-fund revolution

"Socialism" came to America through the efforts of the most unlikely revolutionary of them all, the chief executive officer of America's largest manufacturing company, General Motors (GM). Charles Wilson, then GM's chairman, proposed to the United Auto Workers (UAW) 25 years ago, in April 1950, the establishment of a pension fund for GM workers. By that time pensions had become a priority demand of the American labor-union movement. Yet the UAW was at first far from enthusiastic. It realized clearly that Wilson's proposal aimed at "privatizing" the pension system; and the UAW—in common with most American unions—in those years was deeply committed to a governmental pension system through social security. Moreover, Wilson's proposal gave the union no role whatever in administering the GM pension fund. Instead, the company was to be responsible for the fund, which would be entrusted to professional "asset managers." And the union feared—with good reason, as subsequent events have demonstrated—that the pension

[1] The only exceptions are a few government-owned businesses, such as TVA; farmer-owned producer cooperatives like Sunkist Oranges; policy-holder-owned "mutual insurance companies," such as Prudential and most of the other very large life-insurance companies; and a shrinking group of small companies, in which the founder or his immediate descendants still own the entire business or at least control it.

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fund would thus strengthen management and make the union members more dependent on management. Wilson had in mind a pension fund investing in the "American economy"—that is, in the private-enterprise system; and while this made financial sense to the union leaders, their strong preference until then had been for pension funds invested in government securities—that is, in the "public sector." The union leadership was also greatly concerned lest a company-financed and company-managed pension plan—negotiated with the union and incorporated into the collective bargaining agreement—would open up a conflict within the union membership between older workers, interested in the largest possible pension payments, and younger workers, interested primarily in the amount of cash in the weekly pay envelope. Above all, the union suspected that one of the main reasons behind Wilson's proposal was a desire to blunt union militancy by making visible the workers' stake in company profits and company success. One of the stalwarts in the GM department of the UAW proposed at that time, in all seriousness, that the union should lodge an unfair-labor-practices complaint against Wilson, since his pension proposal could have no purpose except to undermine the union.

But the offer was too tempting, especially to the then rapidly growing number of older workers within the UAW. And so in October 1950, the GM pension fund began to operate.

Actually, employee pension funds in American industry go back to the Civil War, if not before. By 1950 there were some 2000 in operation. One of them, that of the Bell Telephone System, was already very large, and it is still larger than that of any other company and of most governmental units. Employee pension plans, therefore, were far from being a novelty at the time. Nor was the idea of making the pension plan part of the labor contract particularly startling. Indeed, the Supreme Court had ruled in 1949 —a few months before Wilson's offer—in a case involving the Inland Steel Company that employers had to bargain with the union about pensions. And much earlier, the Internal Revenue Service had accepted pension contributions as legitimate and deductible expenses.

Yet the GM plan had an unprecedented impact. Within one year after its inception, 8000 new plans were written—four times as many as had been set up in the hundred years before. And the one innovation of the GM plan was adopted by every single one of the new plans and has since been written into most of the older company plans as well. The GM plan was to be an "investment trust"—that is, it was to invest in the capital market, including

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equities. Practically all earlier plans had been "annuity" plans, to be invested in standard life-insurance investments, such as mortgages and other fixed-interest-bearing instruments. Wilson reached this design in part because he genuinely wanted to create employee ownership of American business. But he also argued that, to be financially sound, pension assets had to be invested in American industry as a whole rather than, as the traditional proponents of "industrial democracy" had preached, in the company for which the employee works. Wilson argued that the employee already had a major economic stake in the employing company through his job and that it would be financially unsound to put his pension investment into the same company, if only because every company and every industry eventually encounters "bad times." Several powerful executives urged Wilson to provide for investment of the pension money in the company's own stock. They argued, and with considerable force, that the workers would only come to accept that their interest and that of the company were identical if employees' pensions were linked directly to the earnings and stock price of the company they worked for. "But where," Wilson retorted, "would that have left the anthracite miners whose industry, in 1912 or even in 1925, was America's most profitable industry, only to disappear 10 years later?" And Wilson prevailed, to the point where his basic rules for pension-fund investment—minimal or no investment in the company for which the employee works; no investment in any company in excess of five per cent of the company's total capital; no investment in any company of more than 10 per cent or so of the total assets of a pension fund —were finally written into the country's laws in the 1974 Pension Reform Act.

The asset build-up

By now, there are some 50,000 or so pension plans. And practically all of them are "investment plans," whether they are being managed, like the GM plan, by a separate, professional, full-time management of their own; or, as is the largest number, by professional "asset managers," above all the trust departments of the big New York City banks; or by insurance companies. The pension funds of the 1000 or so largest companies, at the end of 1974, had about $115 billion in assets. The largest union-managed pension funds had about $35 billion in assets. And the non-business pension funds (other than those of federal government employees)

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had about $50 billion in assets by the end of 1974.[2] Around 70 per cent of these assets are in equities—that is, in the shares of publicly-owned American companies. This adds up to a pension-fund equity portfolio of about $140 to $150 billion at the end of 1974, as against a list price of all companies traded on the stock exchange of about $500 billion at that time—or roughly some 30 per cent (or slightly more) of the total value of the listed companies. The pension funds, and especially the pension funds of private businesses, each year take in about $20 billion more than they pay out—that is, they have to find investment outlets for $20 billion a year. Social security, by contrast—while its total intake and outgo are very much larger—operates by now at a cash deficit.[3]

The Pension Reform Act also gave substantial additional incentives to the self-employed to create their own pension funds, and it forces the larger employers to extend the coverage of their plans. Altogether, therefore, the number of people covered by private pension plans—plans other than social security—is bound to grow, and to grow faster than the work force. In 1973—the year before the Pension Reform Act—about 30 million non-governmental employees, some two to three million self-employed people, and practically all employees of governments—around 15 million more—were covered by pension plans, for a total of almost 50 million out of a work force of 85 to 90 million. By 1985 the number covered by pension plans may be up to 60 million out of a labor force of no more than 95 million, or close to two thirds of the total.

Assets of these pension plans are bound to go up even faster. In the past 25 years, pension-fund assets have doubled every five years. As a result of the 1974 Act, their growth is likely to accelerate quite a bit for the next few years. But even if there is no spurt, the pension funds will continue to grow quickly until the mid-1980's. Then their growth will slow down. Sometime between 1990 and 1995, they should reach a point of equilibrium, with annual income roughly equal to annual outgo. But long before that

[2] Figures for the fastest growing segment—pension plans of the self-employed (the so-called Keogh plans)—are not available; but so far they are probably not too important overall.

[3] Newspaper stories these next few years may report the "folding" of a good many pension plans. But this will be optical illusion. Both the number of plans and the number of people covered will go up sharply. What is happening is that a large number of small-company plans will "fold"—in part because the Pension Reform Act of 1974 demands too much of them, in larger part because the Act gives small-company employees far more advantageous options to build, at less cost and with higher benefits, their own retirement plans (called IRA, for "individual retirement account"). And altogether, these small-company plans, while numerous, cover a tiny fraction of the country's employees.

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—at the very latest, by 1985—they will own the majority of the capital stock of the publicly-owned American business corporations. Economic fluctuations may modify this timetable—though a true long-term depression might actually speed it up, since employment (and with it pension contributions) tends to go down far less sharply in a depression than stock prices. But only continuous double-digit inflation lasting another decade or so could seriously change matters; and even such inflation, while likely to erode —if not destroy—the value of the benefits of the pensioners, is unlikely to affect the asset build-up and ownership position of the pension funds to any significant degree.

Problems of aging

The American pension fund is the most effective response so far to one of the most profound changes in the human condition since the dawn of civilization: the survival of a very large number—indeed of the majority—into old age and past their working years.

It is fashionable today to contrast our "callous disregard" of the old with the "loving care" which they supposedly received in the pre-industrial community and family. But this, of course, is arrant nonsense. The pre-industrial community and family ordinarily did not have the problem of how to treat the elderly: There were so few survivors—even into what we today would call the "prime of life," a man's 50's.

Right through mid-Victorian days every census counted *only people under 50* as part of the "working population." And there were almost no people above that age to be counted. In the famous 1591 census of the Venetian trading port of Zara—a thriving city on the Adriatic—people over 50 (and therefore "too old to work") numbered only 365 out of a total population of 13,441, or one out of every 40. There obviously were no—or very few—people older than 60 or 65. Today, in the United States and in all other developed countries, people over 65 account for more than one tenth of the population (and people over 50, who are older than the traditional "end of the working life," account for a quarter or more of the total population).

Two hundred years after the Zara census the population structure was still the same. Around 1800, Hamburg was probably the wealthiest and healthiest city of Europe, except for Amsterdam, with strict control of immigration to keep out the poor and sick, and with the first city-wide public-health system. Yet in the abun-

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dant and well-researched Hamburg records, people over 50 are conspicuous by their scarcity. The "patriarch" or the "senior" of a patrician merchant family is a man in his early 40's. And half a century later, Balzac still portrayed his *Femme de Trente Ans* as on the threshold of old age.

The early "pension plans" for government employees—those of Austria and Sweden, for instance, which go back into the 18th century—did not provide a retirement pension at all. They were plans to take care of the surviving widow and young children of a deceased civil servant. Those few government employees who did survive to age 65 or so could petition the monarch for a pension. But this was so rare that as late as 1900 the Emperor of Austria—with one of the world's biggest and, by the standards of 1900, most swollen bureaucracies—did not need even one full-time clerk to process the petitions for survival-retirement pensions.

Japan now has the same mortality rate as the West. But a half century ago, when Japan organized its retirement system to take care of what was then considered a rapid increase in older people, retirement was set at 55, at which age the employee got *two years* of salary as a retirement bonus that, it was then thought, would be ample to take care of his remaining years.

The demographic revolution of the last hundred years has thus created, for the first time in human history, both a very large group of "middle-aged" people—people past the age of family formation and childrearing, yet still fully capable of working—and a smaller but still very large group of people surviving, by and large in fair health, into "old age"—i.e., past "retirement."

The pension funds will, of course, only indirectly help with the emotional, physical, and cultural problems of aging, or with the stress which the survival of large numbers of old people puts on the family—though the indirect contribution of an adequate income to individual dignity should not be underrated. But within a few years—no more than 10—the pension funds will have built up enough assets and will cover enough employees to provide a fairly decent income alone to something like two thirds of all Americans reaching retirement age—provided only that inflation does not erode or destroy the accumulated savings.

The unnoticed revolution

The Congress of the United States spent more than two years on the Pension Reform Act of 1974, heard countless witnesses, con-

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ducted dozens of studies, and considered a raft of alternative proposals. But there is not one mention in those thousands of printed pages of the social or political implications of the pension funds, and even very little concern for their economic impact on the capital markets or on capital formation. The entire discussion was on actuarial and portfolio management matters only.[4]

Even more amazing is that the debate over the social and political structure of modern society, in this country as well as elsewhere, pays not the slightest attention to the existence of the American pension fund and to its ownership of industry's equity capital. Indeed, there are quite a few proposals around to invent the pension fund, as if it did not yet exist—and the proposed inventions are vastly inferior to the existing reality.

In this country, for instance, one such proposal that is widely debated is that of Louis Kelso for part ownership of business through the profit-sharing pension funds of its employees. Kelso proposes to make "capitalists" out of America's employees by making them co-owners of the businesses that employ them. But this is financially unsound to the point of recklessness. Some 60 or 70 per cent of all businesses decline during the working life of an employee—that is, over a 40-year period. Under the Kelso plan, employees might indeed be "capitalists," but fewer than half would ever get a decent pension. Furthermore, the Kelso plan ties the employee to a job and a company; the employee does indeed become an "owner," but he is in turn "owned" by the job. If he leaves it, he is likely to forfeit his pension rights, especially if he leaves it when the company is not doing too well. Yet, in the debate on the Kelso plan no one—neither advocates nor critics—shows the slightest awareness of the existence of pension funds which accomplish the Kelso goal of making the American worker into a "capi-

[4] The *only* discussions of the economic and social implications of the pension funds appeared 20 to 25 years ago—well before the pension funds developed into major investors and owners, and well before their impact could possibly be assessed. Altogether, there have been only three such discussions: an article of mine, *The Mirage of Pensions* (discussing the union demands of the late 1940's), which appeared in *Harper's* (February 1950) before even the first of the modern pension plans was born; Adolf A. Berle's *Power and Modern Property* (New York, Harcourt Brace, 1959); and Paul P. Harbrecht's study for the Twentieth Century Fund, *Pension Funds and Economic Power* (1959). Of the three, only Berle predicted major consequences for economic structure, capital markets, and so on—and he basically predicted things that have not happened, such as a decisive impact of the pension funds on industrial relations and "industrial democracy." Since 1959, nothing has been written on the subject—although in the 16 years since, the assets of private pension funds have risen more than tenfold, and their ownership stake in American business has gone up from less that three per cent to around 30 per cent.

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talist," without the financial hazards and social costs of Kelso's approach. And Senator Russell Long, one of Kelso's most ardent disciples, continues to push for special tax privileges for worker investment in the companies for which they work, despite conclusive evidence that the American worker, for sound investment reasons, much prefers the GM-type private pension fund that gives him what he needs—namely, financial security for his retirement years.

The same holds true outside of the United States. In Europe, Ota Sik—at first a highly orthodox Stalinist theoretician, later the economic architect of the "Prague Thaw" and Deputy Minister of Czechoslovakia, and now in exile and a professor at the University of Basel, Switzerland—has proposed to establish "democratic socialism" by building employee retirement funds out of corporate profits, which in turn would then invest in a country's businesses and over the years come to own a controlling share. In Denmark a few years back, a labor government actually introduced a version of the Sik plan into Parliament. Under this proposal, the workers' pension fund—one for the entire country—by the year 2000 would have obtained ownership of about 10 to 15 per cent of Danish industry. The Danish proposal provoked such a storm of opposition, even from the country's Liberals, that it had to be shelved. Yet neither Sik, nor the Danish socialists, nor their opponents, know that something far more "radical" actually has been accomplished in the "capitalist" United States. And when somebody tells them that—as I once did at a congress in Malmö several years back—no one believes it: "We would have heard of it if it were true."

Indeed, no one has heard of it, even in the United States. The worker knows that there is a pension fund, and workers over 35 or 40 years old are vitally interested in it. But not one in a thousand seems to know that through his pension plan he actually owns American business. Union leadership, similarly, knows that there is a pension plan and is very much concerned with its provisions and its investment performance. Yet union leaders seem not to know that the pension plan is actually the "employer" today. Managements know, of course, that the "institutional investors" are the major source of capital funds today, and that "institutional investors" is simply another term for "pension funds." They also know that these "institutional investors" together own the controlling interest in their company and that, indeed, the company could not be financed unless the "institutional investors"—the pension funds—were willing to invest in it. And since the debate about pension

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reform a few years ago, most managements have come to realize that contributions to the pension plan of their own company are a very large and steadily growing cost, amounting in most companies to at least a fifth of the earnings of a good year (which, under the new law, may go up to 40 per cent of profits for many companies within the next few years). But almost no management I know has made the simple calculation which puts together the 20 to 25 per cent of pre-tax profits that go into their own company's pension fund, and the 30 per cent or so of post-tax profits that go to the "institutional investors"—that is, to other companies' pension funds, in the form of dividends. Few yet realize that pension funds, their own and those of others, already get as much of the company's profits as the tax collector—and far more than anyone else.[5]

Nor are pension funds much noticed in the debate over the distribution (and possible redistribution) of wealth. All the familiar figures on wealth distribution entirely leave out the claim to a retirement pension. But the claim to a pension is clearly "wealth." Indeed, it is likely to be the largest single asset for the average American family, exceeding in value the owner-occupied single-family home as well as the automobile, the two traditional "most valuable possessions" of the American family. To exclude it makes any wealth figure a meaningless, and indeed phony, figure. If it were included—which could be done fairly easily on a probability basis—the "distribution of personal wealth," now thought to be far more unequal than the distribution of income, would probably turn out to be very similar. It might even be less unequal, since pension claims are distributed according to age as well as to income.

"Soaking the poor"

Another example of the general failure to perceive the meaning of pension funds is the debate over the corporation income tax. With pension funds emerging as the major owners of American big business, the corporation income tax has become a punitive tax on the American worker. For upper-income people already being taxed at a rate of 50 per cent or more, a corporation income

[5] Here are the 1973 figures for six companies in the chemical industry, ranging from a very large one with sales of $1 billion to two fairly small ones with sales of $100 million a year. Total combined profit, before pension-fund contributions and before taxes, equals 100. Pension-fund contributions (which are, of course, tax deductible) equal 20, leaving a pre-tax profit of 80, on which corporation income tax of a little over 40 per cent was paid. Forty per cent of 80 amounts to 32, which then leaves a post-tax profit of 48, of which institutional investors, practically all pension funds, were entitled to at least 30

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tax of 48 per cent (the present rate) means no additional tax burden. Were the corporate income tax abolished, and these funds disbursed as dividends, they would gain no tax advantage. But for the pensioner who receives all or most of his income from his corporate pension fund, the corporation income tax sharply raises the effective rate of tax on his income. It may bring it to 50 per cent or so, whereas he is supposed to pay no more than perhaps 15 per cent. That part of his income which is his pension—it may be 70 per cent or so—and which represents, in effect, corporate dividends on the holdings of the pension fund, is taxed at 48 per cent; with the pensioner paying another tax, amounting to 15 to 20 per cent on the amount he actually receives, the total in many cases exceeds 50 per cent, and rarely falls much below that figure.

The corporation income tax has thus become an exceedingly regressive tax. Yet, any proposal to reduce the corporation income tax or to allow the individual tax payer to offset it in his tax return is immediately shouted down as a "giveaway to the rich" by the labor unions—the representatives of the very people who are most penalized by the tax. Actually, nothing would so effectively promote greater equality of income as elimination of the corporation income tax, or at least that percentage of it which falls on the holdings of the corporate pension funds. And it would give the lowest income group in the working population, the retired older people, substantially more purchasing power without inflationary impact. This should be obvious; yet no one seems to notice, neither labor-union leaders, nor tax economists, nor even the businessmen who argue (cogently enough) against the corporation income tax as a tax on capital formation and therefore on economic and job growth. All of them clearly still believe that America's large corporations—which together account for three quarters or so of the corporation income tax—are still owned individually by "rich men" rather than collectively, through the pension trusts, by the employees of American business.

Unfinished business

In many ways, this total lack of interest in, and attention to, the

per cent. Thirty per cent of 48 equals 14.5 per cent of the original 100. In sum: With the contribution of 20 to the company's own pension fund plus the 14.5 per cent belonging to other companies' pension funds thus amounting to 34.5 per cent of the original 100, and with the government's share amounting to 32, there is just one third left for everybody else. For 1975—a poor year for the chemical industry—total pension-fund "take" for the same six firms will come close to 50 per cent of earnings.

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pension funds reflects a great achievement. There have been amazingly few "problems."

When Congress discussed pension reform, it talked a great deal about "abuses." But the act that was finally passed, and widely proclaimed as the means to stop these "abuses," only codified, and then festooned with a great deal of red tape, the practices of the pension funds of the country's major companies—in respect to the rights of participants, the investment policies and responsibilities of pension-fund managements, and so on. In particular, the Pension Reform Act legislated the "vesting" of pension rights after a maximum of 10 years of employment, which means that the employee who quits or is fired after 10 years (or more) of service will still receive a pension from his former employer when he reaches retirement age. And the Act further mandates "funding"—the setting aside each year of adequate amounts to build up actuarially sound reserves against future pension claims. But both had been normal practices for large-company pension plans all along. For something like four out of every five participants in corporate pension plans, the Pension Reform Act thus made little practical difference.

The only innovation was something which many pension-fund managers had been proposing for a long time. (I myself had originally proposed it as early as 1950 and it was, even then, not considered a particularly startling proposal.) This is compulsory government re-insurance against the risk of pension-fund failure because a company goes bankrupt or out of business.

But there are nevertheless serious problems, problems that cry out for attention. The 1974 Pension Reform Act concerned itself with those pension funds that least needed attention, let alone "reform": the "corporate" pension funds of individual businesses and the still fairly insignificant but growing pension funds of the self-employed. Congress paid no attention, however, to two other kinds of pension funds—the union-dominated (or union-run) ones, and those of state and local governments (and of the federal government as well). Yet between them, these two kinds account for almost two fifths—about 17 out of a total of 50 million—of all employees covered by pension plans other than social security. Both kinds are in deep trouble and are badly in need of "reform."

The labor-dominated[6] funds usually started back in the 1920's or

[6] I say "labor-dominated" rather than "labor-run" because one of the most important of these funds, the Railroad Retirement Act, is actually an agency of the United States government, even though the Railroad Brotherhoods have had, from the beginning, a decisive voice in its administration.

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1930's, well before the corporate pension funds got going. The Railroad Retirement Board dates back to World War I. These funds are normally "industry-wide"—that is, they cover people engaged in a profession, such as the college teachers, or in a craft, such as construction workers or teamsters—people who, while they normally stay in their profession or trade, also often move around and work for several employers. There is nothing wrong with industry-wide pension funds. Indeed, the largest of them, the Teachers Insurance and Annuity Association (TIAA), which since the 1920's has provided pension coverage for faculty members and other employees of non-profit institutions, has an enviable record of performance as well as integrity. But an industry-wide pension fund that is labor-dominated—the *cause célèbre* is the fund of the Central States Teamsters Conference, headquartered in Chicago, with assets well in excess of $1 billion[7]—tends to be underfunded. Labor leaders, understandably, do not like to increase the pension-fund contributions of their members but prefer to pretend that pensions come "free." Worse still, in a few, but very blatant, cases, they are deeply corrupt, with their investments often in the shadiest ventures, such as Las Vegas gambling casinos, second mortgages on real-estate speculation in marginal resort land or projected entertainment parks, often in partnership with known underground figures with extensive criminal records. Monetary rewards may go to union leaders or their cronies, while exorbitant fees are being paid to union officials and to members of their families for services with no, or dubious, value.

These labor-dominated funds are now officially under the provisions of the Pension Reform Act of 1974. They are supposed to have independent trustees and to conform their investment policy to stringent rules which would exclude a good many of their worst investments. They are supposed to disclose their records and their deals. But so far this is a dead letter and is likely to remain so. In a few isolated cases the Department of Labor, which administers the Act, has insisted on the removal of trustees who, contrary to the new Act, have criminal records. Otherwise the Department is pleading lack of funds for its failure to concern itself with the union-dominated funds. It is likely that only a scandal of mammoth proportions—the bankruptcy of one these funds as a result of its being gutted by its management, for instance—will produce the political will to tackle what for years has been known to be

[7] For the sordid details of this fund, see the *Wall Street Journal* (July 22-23-24, 1975).

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a major problem. In the meantime the participants in these funds—teamsters, in particular, but also coal miners and a good many construction workers—receive pitiful pensions. But at least the remedy—to apply to the labor-dominated funds the minimum standards long prevailing in corporate pension funds—is now on the statute books, though it still has to be applied.

Governmental "involuntary servitude"

The second problem, that of the funds for government employees (and especially state and local government employees), may be more serious. These funds cover far more people than the labor-dominated ones—a total of nearly 15 million workers, or one sixth of the United States labor force. These pension funds for governmental employees are not controlled or regulated by law or by regulatory agencies of any kind. Yet many are in far worse financial shape than any of the private plans, or even the worst-managed labor-dominated plans. Very few governmental units have even attempted to fund their pension liabilities. Technically—and in an increasing number, actually—these funds are insolvent.

The most visible case is, of course, New York City. That the pension liabilities which New York assumed, especially under the Lindsay Administration, have so far not been funded at all made it possible for the City to pretend for 10 years that it "balanced its budget." That this illusion could no longer be maintained was the primary reason—far more important than the erosion of the tax base, the high welfare load, let alone the size of individual pension benefits promised to City employees—why the City went bankrupt in 1975, when it had to meet the costs of increasing retirement without having provided anything for them in the years past. New York is, however, only the most visible case—very few governmental pension funds (including those of the federal government) have funded their pension liabilities any better. All of them have to use an increasing share of their revenues to catch up on pension liabilities already due, even if they cut back pension benefits sharply.

Many governmental pension funds—throughout the nation—also have high costs, an abysmal investment record, and a long tradition of management-by-political-crony. That the Comptroller of the State of New York is the *sole* trustee for the pension funds of the State's employees and is responsible to no one is fairly typical; but such an arrangement would not be tolerated by any private pension fund, no matter how estimable the individual.

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But the basic problem of the governmental pension funds is neither financial nor managerial. It is the "involuntary servitude" they impose on governmental employees—which almost approaches a form of peonage. That this was not "planned," and in fact is largely the outcome of pressure exerted by the employees themselves, does not make it any the less incompatible with social mobility and individual freedom.

The great majority of government employees, including federal employees, are entitled to substantially larger pensions than corporate pension plans provide, and most governmental employees also enjoy very large early-retirement pensions—e.g., 60 per cent of the maximum pension (or 40 per cent or more of their annual salary) after 20 or 25 years of service. Indeed, the rapid escalation of pension benefits in governmental employment has been a major cause of the explosive rise in government (and especially local government) costs these last 15 years.

But with one major exception,[8] public-service employees do not receive one penny if they quit the job with their present employer or if they are fired, no matter what the reason. A public school teacher in New Jersey, for instance, who takes a teaching job in New York State, 10 miles away, forfeits all his or her pension rights. Even the teacher who moves from Glen Ridge, New Jersey, to Bloomfield, two blocks away, loses his pension credits. The same is true for a policeman in Oakland, California. In many governmental units (e.g., New York), to move even from one city department to another, say from the Police Department to Public Works, means total loss of pension rights if done one day before the employee completes his or her 20-year "early-retirement" service.

As a result governmental employees are effectively "tied to the job." The penalty for leaving before the 20-year "early-retirement" date is exorbitant. Worse, employers—and especially other governments—are, with good reason, most reluctant to hire a teacher or a policeman with 10 years of service elsewhere. They cost too much. They have to be paid their full pension when they retire at age 65; and yet they will not have served long enough to have made their full pension contribution. Under some governmental pension plans—again, New York City is a good example—an employee hired at 35 and retiring at 65 will have cost the city around 20 per cent more each year, because of "under-funding" of pension

[8] Faculty with pensions under TIAA who, since TIAA's inception in the early 1920's, have had vested pension rights as soon as they made any payment into their pension accounts.

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costs in his early years, than an employee in the same job paying the same salary and the same pension who started in his early 20's.

Job security and vesting periods

Of all the "abuses" which the Pension Reform Act of 1974 aimed at correcting, none got a bigger play—deservedly—than the long vesting periods (the period before an employee who quits or is laid off has any pension to his credit) of some corporate pension plans and the resulting loss of pension rights of employees who quit or were laid off after years of service and pension contribution. Yet few plans of large corporations had as long a vesting period as the 20 or 25 years that are standard for governmental employees.

As long as governmental jobs could be assumed to have absolute job security, this could be, and was, defended as a minor cost of "local self-government." Public-service unions even resisted any demand for earlier vesting—e.g., by teachers, who of all public-service employees have the highest job mobility—as likely to interfere with their priority goals of more jobs, higher wages, higher pensions, and higher early-retirement benefits. Now that lifetime job security for government employees can no longer be taken as a constitutional right—especially after the cuts in New York City employment—local-government workers and their unions should, if they behave rationally, change their strategy. Early vesting would be for them the most intelligent trade-off for the demands for cuts in final pensions and in early-retirement benefits with which they are increasingly going to be confronted.

Ideally it should be national policy to subject public-sector employers—the federal, state, and local governments—to the same 10-year rule for vesting that is now in force for private-sector employees and their pension plans. In the long run, such a rule would ease the burden on governmental finances and yet improve the economic security of government employees. Governments would find it easier to lay off public-service employees when necessary —e.g., teachers when the number of youngsters of school age drops sharply—while the laid-off employee, with vested rights to pension payments upon reaching retirement age, would find it much easier to get another job. Today the American governmental employee has a far higher pension than government employees in other countries *if* he or she stays with the same employer till age 65 or at least for 20 or 25 years. But the American government employee is far worse off than government employees in any other major

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country (excepting only Japan, on which the American Occupation unthinkingly imposed the American system), who can move freely, at least among governmental employers, and carry their pension credits along.

II. The problems of "pension-fund 'socialism' "

But the American pension system has other, deeper problems than these. One of these, for instance, is the role and future of social security. We may need a far more drastic social security reform than anything envisaged so far.[9] Social security for the majority of American employees is rapidly becoming supplementary, rather than primary, retirement income, the costs of which are high and rising while the benefits go increasingly to other people—that is, to people without an employer or self-employed pension plan, if not as "welfare" payments to people who have made no social security contributions themselves.

But even this kind of problem pales in significance before the general and fundamental questions which "pension-fund 'socialism' " will eventually provoke. These are questions of authority, legitimacy, and control in the economic, social, and political spheres. They are the kinds of questions which arise when one has "socialized" the means of production without "nationalizing" them.

There is, first, the question of the legitimacy of the autonomous institutions of the society, specifically of business and of its management. The emergence of the pension trust makes final the divorce of traditional "ownership" from "control," which has been a favorite topic of writers on the industrial and post-industrial economy since Berle and Means' pioneering book, *The Modern Corporation and Private Property*, written 45 years ago. For the pension funds are not "owners." They are investors. They do not want "control." Indeed, they are legally disqualified from "control." The pension funds are "trustees": It is their job to place the beneficiaries' money in the most profitable investment. They have no business trying to "manage." If they do not like a company or its management, their duty is to sell the stock. To sit on a board of directors, for instance, and accept the obligations of board membership, is incompatible with the duties of the trustee which the pension-fund managers have to discharge and which have been sharply and strictly defined in the Pension Reform Act of 1974.

[9] See Martin Feldstein's remarkable article, "Toward a Reform of Social Security," *The Public Interest*, No. 40 (Summer 1975).

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Yet this leaves management without anyone to be accountable to. And this is clearly intolerable.[10] Management needs to be accountable to an effective board. And this board needs to represent genuine "constituencies."

There is need to balance, in the governance of a large business enterprise, the three interests or "constituencies" which such an enterprise serves: the consumer, the present employees, and the new "owners"—i.e., the beneficiaries of the pension funds.

American management can seriously be faulted for neglecting the consumer interest during the long years of the consumption boom following World War II. It can be accused of catering, instead, to a cabal of investors and workers—to one-sided domination by the "producer interest." This was not for lack of an adequate theory. The "total marketing approach" which became the fashion in management circles after World War II preached that management above all had to represent the consumer interests; but this was rarely practiced. And in this sense "consumerism" can be considered a predictable and needed reaction, and might be called (as I have said several times) the "shame of marketing." If management now defaults similarly on its duties to the constituency of its new "owners," it will lose legitimacy and, predictably, soon lose autonomy. It will come to be dominated by the one organized powerful interest—that of the present employees. Sooner or later the central government will have to come in to restore the balance, which can only mean that management loses its autonomy and decision-making power altogether to government control and to government representatives.

At the same time, the emergence of the pension funds as the new "owners" of American business represents a unique opportunity to restore the legitimacy of management. For this is an "ownership" interest which society *will* accept as legitimate. At the same time, the interest of these owners and the interest of the enterprise are identical—which is not necessarily true of the interest of the two other constituencies, that of the present workers and that of the consumers.

Prospects for management

But how can this identity of interests between the enterprise and the new "owners" be made into overt institutional reality? Pen-

[10] See the chapter, "Needed, an Effective Board" in my recent book, *Management: Tasks; Responsibilities; Practices* (New York, Harper and Row, 1974).

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sion-fund managers have to consider themselves disqualified from service on the boards of enterprises. They have to retain the freedom to sell out the securities of any business. They are investors and should remain strictly investors. Who, then, should serve to represent the new "owners"? How should these people be selected? And how could they maintain the communications and relationships with their "constituents," the future beneficiaries of corporate pension funds?

But business management also has to establish an effective relationship to this constituency to protect its autonomy and, with it, the interest of its new "owners" against rapacious or power-hungry governments, against tax policies inimical to economic growth and the future income security of the new "owners," and against policies—whether originating with government or with labor unions—which are clearly inflationary and, therefore, a direct assault on the long-term interests of the pension-fund beneficiaries.

The best one can foresee today—and it is barely adequate—is the "professional director," the man or woman of public standing and proven competence, who can be truly independent of management.[11] A board led by such "professional directors" would have not only the right, but the clear duty to replace a management that does not live up to its responsibilities and to stringent performance standards. It would, thus, again have the powers which yesterday's "director," representing yesterday's "owners"—the "capitalists"—had and exercised.

But the "professional director" also would have to find some way of reaching *his* "constituency"—the future beneficiaries of the pension funds which supply the capital for the business of which he is a "professional director." He needs to be able to inform them and, in turn, needs to know and to transmit their needs, their wants, their attitudes back to the management of a company. This may be the most difficult task, if only because the "owners"—the future beneficiaries—do not feel any genuine interest in a company and its management. Even their interest in dividends and capital appreciation is remote, cannot be quantified—even imprecisely—and is altogether chancy.

[11] As I have proposed elsewhere, this professional would have to be a person of proven executive capacity; well under retirement age himself; limited to four or five directorships; paid adequately so that his total income from all his directorships would equal the pay of a senior executive; limited probably in his term of office to six years or so, without being immediately eligible for reelection, so as to be truly independent of management; and he would have to be a full-time professional director, without other major work or profession.

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Yet the attempt has to be made. For "pension-fund 'socialism'" can only work if business, and especially big business, continue to retain their autonomy. Should they fall under centralized political control, their profitability—and, eventually, all our liberties—would be eroded.

The legitimacy of management

But the new institutions we have created also need to have management and to be legitimate, and need to represent the beneficiaries and have clear relationships to them. These are much easier tasks. TIAA accomplished them all 50 years ago, when it set up an autonomous management ("asset managers") under a strong board of directors consisting of distinguished economists and university administrators. But by and large, none of the corporate pension funds has as yet organized itself in a comparable way for an accountability and legitimacy consistent with autonomy. They will have to do so. Otherwise it can be predicted, with near certainty, that the first major "scandal" will bring about a plan for government regulation and eventually for governmental takeover.

The asset managers must also be truly independent and free from any suspicion of a conflict of interest. They must serve their beneficiaries and no one else. By historical accident, the bulk of asset management is today concentrated in a fairly small number of commercial banks, mainly in New York City, whose trust departments manage the largest and most important corporate pension funds. The benefit of this to the banks is, at most, marginal. In the banking industry itself, it is said that only two or three of all commercial banks make any money at all out of their pension-fund departments—and those few do not make a great deal, either. But whether pension-fund management is profitable for the commercial banks is not the real question. What matters is that being both commercial banker and pension-fund manager puts the bank into an untenable position. When the Penn Central collapsed in 1970, several of the banks, especially Chase Manhattan in New York, were criticized because their loan officers were said to have warned their colleagues in the bank's trust department of the critical condition of the railroad. Thereupon, the trust department sold pension funds' holdings in Penn Central, thus "trading on insider knowledge." As a result, all the major banks handling substantial pension-fund assets have built a "Chinese Wall" between their commercial lending operations and their trust departments to prevent any such "leaks."

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But this is a worse breach of trust than the "leak" itself! For as a fiduciary, the bank—and it is the bank, and not the trust department, that is the contracting party in law and equity—*must* use its knowledge to protect its trustors. Had the Pension Reform Act of 1974 been in force when the Penn Central collapsed, any corporation whose pension fund was managed by a commercial bank with "inside knowledge" of the railroad's plight, but with a "Chinese Wall" between commercial banking and asset management, could have sued for breach of trust and demanded heavy damages. Indeed, under the Pension Reform Act the corporation's managers probably would have a legal duty to sue the bank, or be liable for heavy damages themselves.

Altogether, being both commercial banker and asset manager does the bank more harm than good. It creates suspicion among its corporate clients. During the credit crunch of 1973-74 many corporate treasurers came to believe that in granting a loan—a decision on which the very survival of the company often depended—the banks favored companies willing to give them their pension-fund business. The banks deny this heatedly, and probably with justice in most cases. But a fiduciary has to avoid even the suspicion of a conflict of interests or he cannot be trusted.

Pension funds are also much too important to be run as a sideline—which is all they can or should be in a commercial bank. Pension-fund management requires and deserves a separate and independent institution, divorced from commercial banking, investment banking, or any other banking business. The obvious model is Canada. There the banks long ago put trust activities into separate trust companies. The trust company still uses the data-processing facilities of a major commercial bank—which an asset manager could duplicate only at substantial cost—while paying for these services through the deposits it maintains in the bank for its own needs. These trust companies are separately incorporated businesses and have their own separate offices and managements.

Safeguarding the assets

The thorniest of the problems of authority, legitimacy, and control is the one problem for which ancient discussion of "The Problems of Democratic Socialism" never had an answer except pious hopes: how to protect the integrity of the pension-fund assets against rapacious governments raiding the pension funds to stuff governmental coffers and to finance governmental irresponsibility.

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This is certain to become a central political problem of American "pension-fund 'socialism.'"

Indeed the raiding is already under way. In Act I of the tragic farce of financing New York City, in the summer of 1975, two of the pension funds of New York City's own employees were "persuaded" to take $125 million of the City's new notes. Four weeks later, in Act II, another four pension funds of City employees were pressured into taking another $165 million. Finally, this rose to $750 million in bonds to be bought by the pension funds of City employees. And when even that proved insufficient to bail out the City, two of the five borough presidents and the City Council President proposed "emergency legislation" to *force* pension plans of companies with offices in New York City to put a portion of their assets into City obligations.

This is, of course, in flagrant violation of the "prudent-man" rules which pension-fund managers are legally obliged to observe. If managers of corporate pension funds were indeed to buy such bonds, and have them default later on, they would be personally liable for damages under federal law and probably even open to criminal charges—"emergency legislation" or not. And those companies that could do so—that is everyone except perhaps the banks —would surely move away, thus hastening the financial collapse of the City.

But how can this be prevented? Perhaps the only effective safeguard is public vigilance—knowledge on the part of the country's employees, and especially of their labor unions, that the pension funds are *their* assets and that they have a vital stake in their political autonomy and financial integrity. This requires, at minimum, clearly visible, autonomous pension-fund institutions with properly organized governance and strong effective links to their "constituencies," the future beneficiaries. It remains be seen whether or not this, too, is but a pious hope.

Economic problems

Just as the rise of "pension-fund 'socialism'" has revived the old "political problems of democratic socialism," it has revived the "economic problems of democratic socialism," and especially those of capital-market and capital formation.

When General Motors, around 1950, set off the pension-fund avalanche, the New York Stock Exchange had just proclaimed a program called "Peoples' Capitalism" to make the great majority

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of American wage-earners "capitalists" and owners of common stock through the mechanism of Wall Street. This was always unlikely to work. Any mass market, such as the one which the New York Stock Exchange envisaged for securities, needs "merchants"—that is, informed buyers for the customers. It needs intermediaries—and the Stock Exchange's idea that the mass-market consumer would buy directly from the "producer"—through the Stock Exchange—was therefore naive to begin with. Today, 25 years later, "Peoples' Capitalism" has turned into "Pension-Fund 'Socialism.'" A far larger number of Americans are "owners"—or rather, legally, "beneficial owners"—of common stock than the Stock Exchange ever hoped for. But the capital market is no longer just Wall Street. The capital market of the United States is now constituted by the pension funds. Wall Street has been overtaken by "structural obsolescence" which has turned it into the country's most depressed major industry.

The Stock Exchange's "Peoples' Capitalism" envisaged millions of individual decision-makers in the capital market—the individual buyers and sellers of common shares. But today's American capital market is dominated by no more than 1000 to 1500 large corporate pension funds. They in turn tend to delegate decision-making to an even smaller group—a few hundred teams of "asset managers": economists, financial analysts, and portfolio managers, heavily concentrated in turn in the largest banks and the largest insurance companies.

The cry of "excessive concentration of economic power" is almost a conditioned reflex to any structural change in the American economy. It is already being heard on Wall Street in respect to the new capital-market structure and will surely soon be picked up in the press, in Congress, and by assorted "populists," whether consumerists or government regulators. But it can be dismissed as a pure red herring. The decision-makers in the United States capital market still greatly outnumber those of any other developed country. Germany's capital market, for instance, functions quite well with three decision-makers—the three large banks which account for four fifths or more of all German capital-market transactions. In Japan the number—again mostly the large, so-called "city" banks—is not much higher. Above all, the United States capital market of the "asset managers" lacks, and will continue to lack, the one characteristic of "concentration": difficulty of access for newcomers. To become an "asset manager" requires practically no capital. It requires only the willingness of a few pension-fund managers to

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entrust a newcomer with management of part of their fund. Almost everyone who has earned his spurs with one of the large asset managers and has got to know a few pension funds can therefore open shop for himself.

Indeed, what asset management today suffers from is "excess of competition." Asset management has become so competitive and so volatile that the participants outdo each other in promising miracles: to "beat the market" or "beat inflation." Both are, of course, impossible. Pension funds cannot "beat the market"; they *are* the market. And as the history of the past 10 years should by now have taught even the most gullible, no one can "beat inflation." It disposses everyone except the universal debtor—government. But because the ability of the asset managers to attract pension-fund business heavily depends on their promises to perform such miracles, they tend to concentrate on the short-term—the next 90 days or, perhaps, the next swing in the stock market. Yet, by definition, pensions are long-term, and pension-fund management therefore requires long-term strategies for true performance; and it is an axiom, and proven countless times, that a series of short-term tactics, no matter how brilliant, will never add up to a successful long-term strategy.

From "entrepreneurs" to "trustees"

The real problem posed by the shift of the capital market to the pension funds and their asset managers is a far more serious one than "excessive concentration of economic power," even if it did exist. Today, capital-market decisions are effectively shifting from "entrepreneurs" to "trustees." They are shifting from people who are supposed to invest in the future to people who have to follow the "prudent-man" rule—which means, in effect, to invest in the past. In this lies a danger of starving the economy of capital for change and growth, and especially of starving the new, the young, the small, the growing business. Yet this is happening at a time when the need for new businesses will be particularly urgent, whether these be businesses based on new technology or businesses engaged in converting social and economic needs (e.g., the provision of "clean air," anti-pollution devices, new modes of transportation, etc.) into business opportunities.

We seem to be in the process of organizing a capital market totally unequipped to supply entrepreneurial capital needs. It is not only that as "prudent men" and "trustees" the asset managers of the pension funds are debarred from entrepreneurial investment.

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Temperamentally they are the wrong people for the job. Investing in the old and existing and investing in the not-yet-existing require different skills, follow different rules, and yield different results. The investor in the existing is, in effect, trying to minimize risk. He invests in established trends and markets, in proven technology, and in proven management performance. The entrepreneurial investor must optimize, if not maximize, opportunity without much regard to risk. To be successful at all, he must operate on the assumption that, out of 10 investments, seven will go sour and will have to be liquidated, with more or less total loss. Of the remainder, two will not do too poorly—but, at best, well enough to offset the seven failures. And one, at best—with the odds very high against its happening—will be a "star," a new Xerox, a new IBM, a new Raytheon, or a new McDonald's Hamburgers. And yet there is no way to judge in advance which of 10 investments in the young and the new will fail and which will succeed. No amount of analysis or of "research" will do any good. Indeed, one cannot analyze or research something that does not yet exist, something that is still promise rather than performance. The entrepreneurial skill does not lie in "picking investments." It lies in knowing what to abandon because it fails to pan out, and what to push and support with full force because it "looks right" despite "infant diseases" and "teething troubles."

These investments in the new business and in the small business a "trustee" is not entitled to make, even if he knew how to make them successfully. Yet if they are not being made, the economy will ossify. What is needed, therefore, are new capital-market institutions which specifically exist to provide the new, the young, the growing business with the capital (and the management guidance) it needs and which, at the same time, are investment vehicles suited for the fiduciary, the asset-manager trustee. Such institutions can develop what the asset manager needs, namely a proven "track record" of performance over a five- or 10-year period. At the same time, they can aggregate in their portfolios the mix of successful and unsuccessful investments which entrepreneurial investment, of necessity, implies.

Such institutions are not unknown. Europe's premier commercial bank, the Deutsche Bank in Germany, was started, well over 100 years ago, to be such a financial entrepreneur. Between the two world wars, the United Dominion Corporation in Great Britain played, successfully, a similar role. In this country, George Doriot, for many years professor of manufacturing at the Harvard Business School, started, before World War II, what is now American

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Research and Development Corporation—the father, or at least the godfather, of most of the "high technology" companies that have sprung up in the Boston area these last 25 years.

Today, however, such entrepreneurial investors will have to be created systematically—to serve both the American economy and the new capital market of the pension funds. What is needed above all is a commitment on the part of the large pension funds to put aside a small but significant share of their assets—perhaps 10 per cent—for investment in such entrepreneurial financing. So far, however, pension-fund management is still trying to guess what the stock market will do in six months' time.

The erosion of capital formation

What is being paid into the pension account of an individual represents "savings" for him. But it is not of itself "capital formation." It is, instead, a "transfer payment," taking away consumer purchasing power from the employed worker and transfering it to a retired worker who, of course, will almost always spend every penny of it.

Social security contributions, from the beginning, were pure "transfer payments," since every penny paid into social security accounts went out immediately as a government payment. What social security called "reserves" were simply government IOU's for money already spent. Corporate pension funds, however, have been forming capital and are still doing so. They have been taking in much more, so far, than they have had to pay out as pensions; and the excess of income has become truly "productive investment," as a rule. But any retirement fund is bound to reach a balance between income and outgo within 40 years, if not sooner. It is then that the youngest employee at the time the fund started approaches retirement age and becomes a "dissaver."

The corporate pension funds for the last 10 or 15 years—the period of their lusty infancy—have been the second largest agency of genuine capital formation in the United States, surpassed only by industry's retained earnings. For another 10 years they will continue to form capital—at a diminishing rate, to be sure, but still on the order of $20 billion a year. By 1985 or, at the latest, 1990, they will, however, have become pure transfer mechanisms—even if their total assets still grow.

Indeed, by that time the pension funds are likely to lead to *negative* capital formation. As more and more of the beneficiaries

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age and begin to draw retirement benefits, the funds will increasingly need cash income, rather than capital gains. They will need dividends, in other words, and will have to put pressure on the companies whose stock they own to increase dividend pay-out and to decrease retained earnings, and with them capital formation.

The individual United States citizen, as benefits his income standard, has a high "personal-savings" rate. The United States economy, however, has, as is well known, the lowest rate of "true savings," or capital formation, among developed nations. The explanation for this apparent paradox is that most of what the individual considers "savings" is, economically speaking, "consumption" or, at best, "pseudo-savings." One reason for the high individual, and low economic, savings rate is America's high rate of home-ownership; the residential home may be an "asset" for the individual, but is, economically speaking, a "durable consumer good" rather than a "productive investment." It has a "trade-in value" but no "wealth-producing capacity." It is not "capital."

Another reason is social security—now 10 per cent of wage income (excluding the two per cent paid jointly by employer and employee for health care after age 65). Again, this is "savings" for the individual but a "transfer payment" for the economy. And the private pension plans now add to this another five to seven per cent of wage income of which around two per cent today still represents genuine "savings" and capital formation—but not for very much longer.

Altogether, then, the "individual-savings" rate in this country exceeds 25 per cent of personal income and approaches 30 per cent —but the "true-savings" rate approaches zero. Retained earnings of corporations, at their very highest, run to no more than three to four per cent of total personal income. But a three to four per cent rate of capital formation is well below what is needed for replacement needs alone, and leaves nothing over for additions to the stock of capital. And we face, as everyone realizes, a period of very high demand for new capital—for energy, for the environment, for a railroad system drained of capital, for the inner city, and also for increased productivity in agriculture to feed a hungry world. Moreover, for another five years we also will have to create one to one-and-a-half million new jobs every year to take care of the babies born during the "baby boom" of the 1950's, now grown to adulthood; and each job in the American economy requires an average capital investment of $40,000 or more.

Demographics rather than the pension funds are the root of the

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problem. We now have to support one older person for every four of working age. Were this money now spent on their support available instead for genuine capital formation, there would be no problem at all. Indeed we would probably "oversave" with our present rate of "personal" or "pseudo-savings."

The tendency towards "undersaving"

But while the pension funds are not the cause of the squeeze, the fact that they will soon be inadequately performing the job of capital formation is going to be a fundamental and permanent problem of "pension-fund 'socialism.'" Indeed it may be *the* economic problem of "pension-fund 'socialism.'"

The problem is made all the more acute by the widespread belief that contributions to social security and pension plans are "savings." This tends, quite understandably, to cut down sharply the whole economy's propensity to save. It thus creates a permanent tendency towards "undersaving" rather than the "oversaving" which Keynes and the Keynesians postulate as the "normal" tendency for a developed "capitalist" economy. And the theoretical implications, though simple, are startling. If "pension-fund 'socialism'" has a built-in tendency towards undersaving, policies to stimulate consumption can have one and only one result: *They will stimulate inflation.* And they will do so regardless of economic conditions—in a depression as well as in a boom, in times of idle resources and unemployment as well as in times of high plant utilization and full employment. The only effective economic policy, and especially in a recession, would be one that stimulates genuine capital formation—a policy diverting resources from consumption into productive investment.

This is not quite so novel a conclusion at it may sound. Joseph Schumpeter anticipated it—first in his 1918 essay on the "fiscal state" and then in later writings, especially in his classic *Socialism, Capitalism, and Democracy* in 1946. More recently Robert A. Mundell, the Canadian economist now at Columbia, has reached very similar conclusions, based on 20 years of study of the world economy and of the impact of traditional monetary policies on prices and incomes.[12] Still, it is a conclusion that is totally at odds with classical pre-Keynesian economics, with Marxist economics, and with the now dominant Keynesian and post-Keynesian (e.g., Friedmanite)

[12] See the article, "The Mundell-Laffer Hypothesis," by Jude Wanniski in *The Public Interest,* No. 39 (Spring 1975).

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economics. It does not, as did classical economics, assume the truth of "Say's Law"—that is, it does not expect automatic market forces to maintain a self-regulating balance between consumption and investment. It also, in sharp contrast to Marxist economics, does not consider "capital" a political "rip-off" of the "system," but treats it as a fundamental "factor of production," one that is a necessary "cost of the future" of *any* economic system, caveman, capitalist, or communist. Finally, it implies that "pension-fund 'socialism'" is structurally different from the "mature capitalist economy" of the Keynesians. And what makes it different is precisely that "personal savings"—as a result, largely, of the pension-fund mechanism—no longer represent a "capital fund" but are "transfer payments" for purposes of "consumption."

The central problem of American economic policy will thus have to be the stimulation of "genuine savings" so as to attain the minimum rate of genuine capital formation—maybe eight or 12 per cent of total personal income—needed for economic maintenance, let alone for economic growth at least at the same rate as labor-force growth. There are only three ways of achieving this.

One is to increase personal savings over and above the present, and fairly high, rate of "pseudo-savings"—savings for residential homes, social security, and private pension plans. What incentives would be needed? And what institutional channels would have to be constructed to make this possible?

The second way is to increase the share of capital—whether in the form of after-tax interest payments or after-tax corporate profits—in the nation's Gross National Product. In many ways this would be the least painful solution, if only because it would be helped along by market forces which, under "pension-fund 'socialism,'" will tend to raise the costs of capital anyhow. It would also be the way that best fits existing financial structures.

The third way is forced saving, such as the Soviets' "turnover tax," which is, in effect, a tax on consumption to provide the capital for the Russian economy. This is not only a wasteful way to form capital—for, as in Russia, profit margins then have to be several times greater than those that prevail in a market economy. It also means a very low productivity of capital. And it would, of course, hardly be compatible with the survival of free institutions. For as long as a government remains under control of an electorate, it is most unlikely to be permitted to form capital; whatever it takes in—except maybe during short, wartime periods—tends to become consumption through "transfer payments."

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Demographic problems

Those few economists who pay attention to population and demographics point out that the ratio between "productive population" and "dependent population" in the United States is not deteriorating and may actually improve. For the number of small children is going down faster than the number of old people past working age—those past 65—is increasing.

This is, however, irrelevant. The worker who takes $20 out of his own pay envelope to buy shoes for his own children does not look upon this as a "transfer payment." He is not supporting a "stranger." As long as the money stays in the family, he does not see himself as cutting down on his own consumption to support a "dependent." The same $20 taken out of his paycheck to be put into a pension fund or into social security is, however, a cut in his income and in his purchasing power. In other words, what matters socially and politically is not the ratio of "productive" to "dependent" population, but the ratio of productive members of the working population to the no longer productive, retired adults.

This ratio will, however, deteriorate quite sharply as the number of young workers entering the labor force goes down, beginning in 1978 or 1979. At the same time, we can no longer expect the proportion of working wives in the labor force to increase significantly. We probably have reached saturation point. Women in the labor force may get better jobs and greater opportunities, especially if economic conditions are propitious. But their total number or proportion is unlikely to increase.

The tension between the amount needed to support the retired adult population and the cash needs of the presently employed members of the labor force, therefore, is certain to increase—even though the overall ratio between dependent people (including children) and productive people in the total population may actually improve. In fact, in a few years—if retirement age stays at 65—*every four Americans at work will have to support one retired worker.*

It has become almost an axiom of American politics that taxpayers have no resistance against increases in social security and pensions costs. But this axiom is gradually losing its validity, and we can confidently expect greater conflict over this issue.

The first problem is the conflict between older and younger workers. Older workers have the greatest interest in pensions and therefore, in any wage settlement, press for the largest increase in pension benefits rather than in wages. Younger workers, under 40

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or 45, do not really think much about their retirement as yet—it is too far away. Above all, it is in the younger age group that there is the greatest need for cash income. These are the years of cash pressures: for children and their shoes; for housing; for furniture, appliances, recreation, and so on. But it is precisely in these early years in which provision for retirement income should be at a peak. A dollar invested at age 29 at six per cent will be worth $8 at age 65, whereas the same dollar invested at age 53 will be worth only $2 at age 65.

The cheapest method of financing old-age pensions would surely be to put the entire burden on people under 45. After 45, and especially after 50, putting money aside for retirement produces only insignificant retirement income. For the marginal utility of money set aside in the last 10 years before retirement is very small, probably a good deal smaller than the value of the satisfaction the payer might obtain by spending the same amount. The marginal utility of a dollar invested early in retirement is exceedingly high. But its "opportunity cost"—the cost of not using the money for other purposes—is even higher.

The American worker, white collar as well as blue collar, has reacted to this dilemma in a perfectly rational way—a way, however, which threatens to cripple the economy and, above all, the pension system. Workers have little resistance, it is true, to increasing retirement pensions—on condition only that their cash wages go up at least fast enough to compensate for the increased contribution for social security and pension funds! Cash wages in the mass-production industries, it is often pointed out, did not increase faster than productivity until the late 1960's, so that they had no inflationary impact until then. But *total wage costs* began to increase very much faster than productivity in the early 1960's. One reason for this was the spiralling of health care costs that set in during the mid-1960's. But just as important was the increase in both social security costs and, especially, in private pension costs which began around 1960. Whether the employee pays these charges or whether they are being paid for him by the employer is irrelevant. They are "wage costs."

In the early 1970's, these costs accelerated again, as a result of the very large number of young people entering the labor market at the very same time the number of people entering retirement age also increased quite sharply.

The best (or worst) illustration of the effects of this built-in tension within the labor force is the pension plans of New York

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City, which are, in such large measure, responsible for the City's financial distress. It is easy to criticize Mayor Lindsay for having made such exorbitant settlements with the unions of City employees. But the Mayor, as well as the leaders of those unions, were caught between the older members who wanted substantial pensions, and the young employees who wanted and needed maximum cash income. The result, given New York City's political realities, was a foregone conclusion: settlements which both raised the wages for the working employees beyond the City's capacity to pay, and pension plans which did the same—leading to an explosion of New York City labor costs within a few short years. New York was not unique: To a somewhat lesser degree, such inflationary pressures were experienced throughout the entire economy.

The chronic labor shortage

At the same time, we have not resolved the tension between the people at work and the needs of retired ex-workers on pension. The over-65 population in America now amounts to over 23 million people. It is just about 10 per cent of the total population. But it amounts to more than a quarter of the 1975 working population of 85 million. And even if we had "full employment" (i.e., a working population of 90 million) the ratio would not change significantly. Within the next 10 years the number of people past age 65 will rise quite sharply to around 30 million—the end result mainly of the sharp drop in infant mortality in the second and third decades of this century. Only after 1985 or so will the number of older people level off—only to rise sharply again around the year 2010 when the "baby boom" children of the 1950's will reach retirement age. And parallel with this rise in the number of elderly there is growing pressure for "early retirement."

The working population, however, will not rise anywhere near as quickly as the number of older people during the next 10 years. For the babies of the "baby boom" years are now mostly in the working population; and the new recruits will increasingly come from the years of the "baby bust" that began in 1960 and continues until now. The total working population by 1985, assuming "full employment" (i.e., unemployment of no more than four per cent of the total labor force), will run to around 95 million. Today, in other words, our demographic changes, operating through the retirement system, have created a one-to-four dependency ratio. Within 10 years it will deteriorate to a one-to-three ratio.

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On that basis the amounts we presently set aside for pensioners through the combined contributions of employees and employers—10 per cent of wages through social security and another five to seven per cent through private pension plans—should provide retired people with 50 to 60 per cent of the income the primary breadwinner had while working. At least this should be the figure once the beneficiaries of private pension plans have been enrolled long enough to qualify for full benefits—i.e., after 1980 or so. But is this enough? Or is it too much? In terms of general policy everyone is, of course, in favor of generous retirement pensions. In terms of specifics, everyone—almost every employed worker regardless of age—opposes paying out more of his income to support the aged and retired. If their income goes up—that is, if he has to increase his contribution to the social security and pension funds which pay the retirement bills—he expects at least a compensatory increase in his cash wages to "stay even." And the result is again inflationary pressure.

These tensions between younger and older workers and between employed and retired people cannot be eliminated. But they need not be aggravated by the pension system, as they are being aggravated today. The American pension system still reflects the realities of 50 years ago when the idea of social security was first conceived in the mid-1920's, and of 40 years ago when social security was actually born in 1935. It still aims at reducing "labor surplus" by forcing people out of the labor force when they reach a certain arbitrary age. And the private pension plans have taken over, unthinkingly, the same intention.

But we now face—as very few people seem to realize—a long period of chronic labor shortage. The late 1970's are the last years in which large numbers of young people will enter the labor force. Beginning around 1979, when the children born in the early 1960's will reach working age, we will live with the long-term effects of the "baby bust" which began in the years 1960-61, when the number of children born dropped by an unprecedented 25 per cent.

Even if there should be reversal of the birth-rate trend—so far there are few if any signs thereof—it would be 1995 before there could be an increase again in the number of young people reaching working age. Meanwhile, the number of people reaching retirement age and leaving the labor force will grow only slowly, at least till around 2000, when the low birth years of the depression will reach age 65. *For the next 20 years labor-force growth in Amer-*

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ica will be close to zero-growth—as a result of events that have already happened irrevocably.[13]

Our pension plans equally assume the vital statistics of the 1920's and early 1930's. Then, indeed, 65 was the age of average death expectancy for white male Americans who had survived infancy. Today the age of average death expectancy for the same white male American is around 72 or 73 (higher for women, of course). And the capacity of older people to function, especially in the 60 to 70 age group, has been going up even faster—if only because the available jobs require increasingly less physical strength and impose increasingly less physical strain than the jobs of 40 or 50 years ago. One cannot hoe the cotton patch if one needs a cane to walk. But one can easily be a telephone operator or even a truck driver.

The pains of retirement

What is needed, for humanitarian reasons as much as for economic ones, is a policy which enables people to retire early if they so desire, but which, at the same time, gives them incentives to continue working. Mandatory retirement before a worker reaches the age of average death expectancy—before 70 or 72—is hard to defend and, in effect, is an anachronism. Our present system, however, penalizes older people who keep on working. Social security, for instance, does not allow a male to earn any substantial income till he is 72, on pain of losing all or most of the social security benefits which, supposedly, he has fully paid for. Private pension plans do not penalize a man or woman for earning something, provided it is not with the employer out of whose pension plan he or she is being paid. But they offer even less of an incentive to keep on working than social security where, within the last few years, the law has been amended to give a person who keeps on working without drawing his social security benefits a slight—a very slight—improvement in future benefits.

What we need is a deliberate policy to encourage people to keep on working without penalty and with a sufficient incentive—e.g., materially increased future income (which actuarially is not too

[13] The figure of "95 million jobs needed in 1985," used by President Ford in his 1975 Labor Day Speech and contrasted by him with the 85 million jobs of 1975, actually means almost no labor-force growth. For it assumed the "acceptable" unemployment rate of four per cent for 1985 instead of the nine per cent rate of 1975; and with four per cent unemployment, the 1975 labor force figure would be around 90 million.

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difficult to do)—and with guaranteed death benefits should they die before they have drawn their pensions for a given number of years. We should also make it possible for people who have chosen early retirement to come back into the labor force and especially back to their former employer. Their pension payments should then be suspended, perhaps, but their pension rights should be fully maintained. For we now know that while a great many people want to "retire early," a great many also find out after a short time that they really only wanted a long vacation and would love nothing better than to go back to work again—and not primarily even for the sake of the income, but for psychological satisfaction, companionship, and stimulation.

Today with high unemployment and with the last cohorts of the "baby boom" just entering the labor force, all this may sound like pure fantasy. The time to do these things, however, will come soon—the early 1980's when job pressure from the new entrants into the labor force is certain to abate sharply, while at the same time resistance against increasing pension contributions is bound to go up equally sharply among the younger employees. And if the labor unions—who are still caught, by and large, in the verities of the 1930's—continue to oppose such changes, they may soon find that the alternative is actually even less to their liking: a steadily spreading "Japanese system"—a system in which people take their pensions and then go to work at much lower wages elsewhere, thus undercutting the entire union rate system. This is already happening in the construction industry. The "non-union" workers who, all over the country, are taking away construction jobs from union labor, are not "outsiders"; they are, in large numbers, retired union members who draw benefits from a private pension plan and then go to work for much less money for a non-union contractor.

But we also need to tackle the conflict between the young workers' need for cash to spend and the advantage to them of paying in retirement money while they are still young. Now that employee pension rights are vested after 10 years of service, it should be possible to provide "anticipation finance" which enables the young employee to pay in substantial amounts into his retirement fund through a form of installment credit, which he then repays out of the retirement premiums of his later years. The risk of survival could be handled by means of the group life insurance which most employees under pension plans carry anyhow.

The young employee, by and large, knows perfectly well that it is in his interest to pay in the maximum amount early—compound

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interest is not that difficult to grasp. If given the incentive to do so and the means, he is likely to avail himself of them. Here, in other words, lies one of the most needed innovations in finance —and one the pension funds themselves could probably work out, given a little ingenuity and some hard work.

Insiders and outsiders

There are also serious tensions within the older retired population. It may seem odd, in this statistic-happy country, that no one really knows how many people are covered by pension plans other than social security, and how much by way of a pension they are likely to receive when they retire. And to translate such figures as are available for individuals into family or household figures—into meaningful figures—is beyond anyone's knowledge or competence.

But it is reasonably certain—barring only continuing sharp inflation—that from the early 1980's on, when the private pension plans will begin to approach maturity, about two fifths of all working people reaching retirement age can expect a household or family income of some 60 per cent or more of the main breadwinner's pre-retirement income—that is, a modest but fairly adequate income, composed of both retirement pay from a private pension plan and social security, with the private pension accounting for half or more of the total. To this might be added a smaller group—at most another fifth—with enough retirement pay from a pension fund to "sweeten" social security and to bring retirement income up to around 45 to 50 per cent of pre-retirement earnings.[14]

These two groups will be relatively well off. Barring serious inflation, they should be able to manage, though rarely with much to spare or to lay aside. But the next group—maybe a third of the labor-force members reaching retirement age—will have only social security. If they get any retirement income from other sources, it will be too little to make a difference. They will at best have a bare subsistence income. For, since many of these people will have had poorly-paying jobs and intermittent employment, their social security benefits will be low to begin with. They will

[14] These figures take into account that social security payments are tax-free in their entirety and private-pension payments tax-free at least in part, so that retirement earnings have to be compared with pre-retirement earnings after taxes and after social security deductions. In most of the published figures on the incomes of old people, their new tax status is not considered.

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have Medicare for hospital bills. But they will find the additional premiums for physicians' bills under Medicare a real burden.

And then there will be a fairly small group—less than a fifth of the people reaching retirement age—who will have no retirement benefits at all. Those relatively few among them who will have been on welfare in a big city all or most of their lives, will, at least under today's rules, be taken care of fairly well. The others, however—the chronically sick or severely handicapped, for instance; people who worked for themselves as farmers, craftsmen, or small shopkeepers without building up a self-employed pension plan or adequate savings; or single women who took care of an old parent and therefore never earned wages themselves—will get nothing or next to nothing. They will, in effect, be destitute. This fourth group poses a problem of "social welfare" which no pension system can handle, and which no pension system should be expected to handle.

But the third group, the group that had poor jobs during their working lives and now has only fairly low social security benefits, *is* a serious problem. It represents the "proletariat" of the old-age population, and will contain a disproportionate number of blacks, and an even more disproportionate number of widowed women. No "pension reform," no incentive to postpone retirement, no funding and vesting can help them much, if at all. They were, after all, "marginal" as workers, which is why they are "marginal" as pensioners.

This is a problem that cannot be tackled within the pension system, whether private or social security. The relatively small sum needed to bring old-age income for the old-age "proletarians"—the former "working poor"—up to a minimum standard will have to come out of general tax revenues and be paid as "welfare" rather than as "insurance" or "pension."

And this leads to the most unexpected of the problems of success created by the private pension funds: the future of social security.

From "insurance" to "welfare"

Social security was founded in the mid-1930's on two principles. First, social security was to be gradually expanded until it would become the universal retirement system in the United States—excepting only railroad workers with their older and then well-established retirement plan. And social security would, for those covered (practically everybody in the end), be the only or at least the principal source of retirement income, except for individual savings.

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Second, it would be "insurance" rather than "welfare": Benefits would equal on a probability basis what the employee (together with his employer) paid into his account. Reserves, while totally invested in government bonds, would be actuarially sound. Above all, anything not strictly "old age and survivor" insurance would not be permitted to become mixed, whether financially or administratively, with social security.

Both principles are still being invoked in social security rhetoric. And indeed social security now covers virtually all people at work in the United States, whether employeed or self-employed. But in actuality both principles have been abandoned. Barring another five years of double-digit inflation which would undermine the entire private pension system, social security will have become by 1980 the supplementary, rather than the primary, source of retirement income for the majority of the country's working people reaching retirement age.

At the same time, social security is rapidly changing from a pure "insurance" system to one dominated by "welfare." The bulk of social security payments, of course, still serve the original task of providing "old-age and survivor" insurance. But six out of every 10 social security employees work on the new "welfare" tasks: Medicare and the monumental case loads of "supplemental security income" benefits to the "needy aged, the blind, and the disabled," which were transferred from the states to social security on January 1, 1974. The bulk of administrative expenses—and this, of course, also means the bulk of administrators, supervisors, and clerks—in the Social Security Administration already goes to "problems" and "needs" rather than to "claims" and "rights." Supplemental security income payments in 1973-74—their first full year under social security—acounted for one twentieth of total disbursements by the Social Security Administration—some three billion out of a total of almost 70 billion. Supplemental income clients are just about one eighth of the total recipients of social security checks—three million people out of 25 million. But its administrative expenses of $500 million—and that also means the people employed in administering the program—were one fifth of the total social security budget and fully one half of what it costs to run the entire "insurance" program—that is, the "old-age and survivor" pension (the rest goes for the Medicare programs). Moreover, it is only a matter of time before Medicaid—the health-care program for the "medically indigent"—will be shifted to the Social Security Administration. There is no other place for it. And the Food Stamp Program—another

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"welfare program" in deep trouble—may also end up in social security before long.

To abandon the original principles may have been a very unwise thing to do. But it is accomplished fact. And, as a result, it may well be the only intelligent—perhaps even the only practical—thing to carry the developments of the last 25 years to their logical conclusion: to convert social security altogether into a "welfare" rather than an "insurance" system—a "welfare" system which takes care of the elderly "proletariat" already mentioned, the handicapped and disabled, and so on. These "problems" cannot be provided for out of any kind of genuine "insurance." To the extent to which they are being supported, they will be paid for out of general revenues, out of bona fide taxes.

A reform of social security?

For two thirds to three quarters of the work force social security would then become "re-insurance" of the real insurance program: the employer's pension plan. Such pension insurance, necessary in case the corporate pension plan founders, for whatever reason, would remain compulsory; and some payments into a central fund will have to continue—for health-care costs after retirement, for instance, or until the employee has acquired a "vested" claim to retirement benefits. But to the extent to which employers' pension plans provide for a certain minimum income if contributions are continued until retirement—say 50 per cent of the income of a family's primary income-earner—social security payments would either be cut back or waived altogether. And national policy might clearly establish a preference for providing retirement income through private plans to the fullest extent possible.

Such a reversal of the official policy of the last 40 years may seem today to be a political pipe dream. Actually, we already have moved very far down this road—perhaps halfway. While social security has been drawn more and more into welfare programs, tax policy has been increasingly favoring private pension plans of all kinds. Money paid into private pension plans is treated as deferred income on which taxes are payable only when the benefits are received after retirement. (The social security contribution of the employee, on the other hand, comes out of income *after* taxes.) Employees of non-governmental non-profit institutions—private universities, for instance, or charitable organizations—have what are known as Option III and Option IV, under which they can defer

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taxes on large chunks of their income if they pay it into a private pension fund. In the Pension Reform Act of 1974, Congress went even further. It granted self-employed people the right to defer up to 15 per cent of their income, or $7500 a year, provided it is put into a pension plan. And for employees not covered by a private pension plan, it provided for a tax deferral of up to $1500 a year (or 15 per cent of income, whichever is smaller) if put into an approved pension plan—the so-called IRA plans (Individual Retirement Accounts). We will soon go further: The IRA provision is bound to be liberalized; for there is really no reason why employed people not covered by a private pension plan should not be able to defer income up to the same amount that is permitted to the self-employed—that is, up to $7500 a year. And there is already a good deal of pressure to grant *all* employed people under a private pension plan the tax-deferrals of Option III or Option IV, so that they can set aside additional sums for future retirement. In fact, such liberalization of private pension contributions is the easiest, and politically most attractive, way to combine tax cuts with an "anti-inflationary policy." It also greatly eases the conflicts between workers who want more cash and workers who want a higher pension contribution. Flexibility in pension contribution through tax incentives for individual contributions to the pension account should also help to counteract the growing resistance against rising social security costs.

At the least, the emergence of the private pension funds as the primary source of retirement income—while at the same time, the social security system is increasingly becoming "welfare" rather than "insurance"—makes it highly probable that social security reform will go well beyond what is now meant by this term. Any attempt at social security reform is likely to reopen the whole question of the role of social security—a question which, 40 years ago, the framers of the present system thought had been settled for good. What we now pay for is largely the system they envisaged; what we actually get is a system in which private pension plans carry more and more the main burden, with social security acting in part as "re-insurer," but increasingly as the welfare agency for the non-insurables.

III. The lessons of "pension-fund 'socialism'"

When Charles Wilson proposed the first of the "modern" pension plans 25 years ago, he was certain that there would be a pro-

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found impact on industrial relations as well as on human relations. (It was this argument that persuaded a skeptical GM board to accept Wilson's proposal.) The people who today are proposing that we invent the pension plan all over again—Louis Kelso in this country or Ota Sik in Europe—again promise that tying business performance to the employee's financial security, through pension plans investing in company stock, will bring about an industrial utopia. Yet "pension-fund 'socialism'" has had no impact whatever on either industrial relations or human relations. And one can say quite positively that no such plan will or can have any such impact.

As a matter of fact, a century and a half of earlier experience had already proven that industrial relations and human relations are not functions of "ownership"—and are indeed not determined by anything external to work and job themselves. Even total ownership of a business by the employees rarely by itself affects industrial and human relations. One example is Zeiss, the German optical company, given to the employees in 1906—without any great impact, if any, on industrial and human relations in the company. Today, outside of the United States, the same non-results are reported from Yugoslavia, where the workers both "own" and presumably "control" the country's larger businesses.

But the most massive experiment is certainly the American experiment of the last 25 years. It should, once and for all, explode the myth which sees the key to "industrial warfare" or "class warfare" or "alienation" in "ownership" or in any other such facet of "the system."

One reason this is a myth is a simple economic one: No matter how lush the profits of a business, the employees' main and primary interest is in the income from the job. And profits, even in good years, rarely run—even in the most profitable business—to more than one tenth of labor costs. Hence the job, even in terms of its economic benefits alone, is quite properly 10 times as important to the employee as sharing the profits or sharing the ownership. Income from profits can provide "fringe benefits," such as a retirement pension. But profit-sharing or employee ownership cannot be of more than marginal importance to the employee, in economic terms.

And in political or psychological terms, they are not even of marginal importance. For what is central there is "management"—the work, the assignment, the boss, and the relations within the work group. This does not mean that the "system" is irrelevant. No matter how well managed the work and how much might be done

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to give the worker a sense of achievement, slavery, for instance, would be most unlikely to result in "good industrial relations." The "system," in other words, can destroy. But no "system" can create harmonious or even stable industrial relations and human relations. Industrial relations and human relations are not primarily macro-phenomena. They are primarily micro-phenomena—the results of the management of work by management and the management of the job by the worker. Both can be affected only at the workplace, by redefining the relationship of a specific worker to a specific job. The problems of work and job cannot be remedied by changing the "system."

But as long as the belief prevails that changing the "system" can change industrial and human relations, the responsibility of management to make work more productive and at the same time more humanly satisfying will always be avoided. We have had, by now, a long historical experience in ways of making work a more satisfying experience. What is needed is the will to learn from this experience and to apply the lessons. That isn't always easy; but it is never impossible. And it is always *management's* task—whatever the "system" in which management operates.

Beyond "socialism" and "capitalism"

American "pension-fund 'socialism'" has also exploded the old myth that "management"—or rather modern, large-scale organization—is a result of the "system," and especially of the capitalist system. That the domination of modern society by large-scale organizations presents problems is obvious. But it should also be clear, from the experience of the United States in the last 25 years, that such a condition is not the result of the "system" and will not go away if the "system" is changed. Not only is there going to be no "withering away of the state"; there is going to be no "withering away of large organizations" and, with them, of "management," with all of its prerogatives and responsibilities. In fact, "pension-fund 'socialism'" demands large organizations; for the pension funds of the American employee can only function if there are large businesses with a high degree of continuity. And the same is obviously true of any other form of socialism.

Altogether, America's "pension-fund 'socialism'" teaches that the 19th-century ideologies of the "system"—the juxtaposition, especially, of "capitalism" and "socialism"—have become obsolete, if not meaningless. "Pension-fund 'socialism'" is genuine "socialism"; if

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anybody, 100 years ago, could have foreseen this outcome, he would surely have predicted it to have profound impact on the "system." Power relationships would change radically; the role and function of management, if not our institutions themselves, would be changed drastically; and the basic politics of the country would somehow change from top to bottom. None of these things has happened. In fact, the coming of "socialism" to America has not had the slightest discernible impact on American institutions—on American power structure, American politics, or even on American political rhetoric. Indeed we have created a genuine "socialism" linked to, and indeed made possible by, a genuine "capitalism," if by "capitalism" we mean resource allocation in and through a market mechanism.

So the impacts of "pension-fund 'socialism'" on the "system" can only be called trivial. Socialism trivial? The very idea seems preposterous, considering the fervor with which socialist panaceas of all kinds are being embraced by all critics of the "system." But maybe this is the fervor of despair, the fervor of *credo quia absurdum* in which the "true believer" takes refuge when his millennial dream comes up against reality.

For the reality, and the great lesson of the American experiment, is that the alternatives today are not those of the 19th century[15] —i.e., "capitalism" or "socialism," or even "individualism" and "collectivism." If the American experience proves anything, it is that the fundamental conflict in the developed countries—for all that it invokes the old battle cries and waves the old banners—is not about "capitalism" and "socialism." *It is about power.* It is a conflict between those who want a decentralization of power, a society in which a substantial number of pluralist power centers make decisions, thus leaving a meaningful sphere of freedom for the individual, and those who wish for a monopoly of power by a small élite, one which keeps itself in power either by brute force, or by buying, through "transfer payments," the support of the less productive or non-productive groups. Marx would have called this élite a cabal of the "lumpen intellectuals" and the "lumpen proletariat."

The emergence of "pension-fund 'socialism'" came about without benefit of government programs—though with some help from governmental legislation. Not many people today, in this or in any

[15] A conclusion that Daniel Bell reached from entirely different premises in his *The End of Ideology* (1960). See also my book *The Landmarks of Tomorrow* (1959). Neither book, of course, anticipated the pension-fund development that was just starting then.

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other developed country, believe fervently anymore in governmental "programs." Indeed, the cynicism regarding the capacity of government to deliver on its programs—other than to build a big bureaucracy and to spend a good deal of money—is a real danger. But while our generation has lost the almost unlimited faith in government which prevailed in the 1930's or even still in the early 1960's, nothing else has taken its place. There seems to be no alternative.

That non-governmental action has produced a profound change through the pension fund may therefore be of great importance. In fact, one might—without too much exaggeration—say that it is the *only* economic and social program of the last 30 years that has truly produced results and has delivered what it promised. Pension funds are collectives, but they are "non-governmental" and, in that sense, "private." They offer an outstanding example of the efficacy of using the existing private, non-governmental institutions of our "society of organizations" for the formulation and achievement of social goals and the satisfaction of social needs.

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"Affirmative action" reconsidered

THOMAS SOWELL

IMAGES and labels have taken the place of facts in the controversies surrounding "affirmative action." Words like "quota," "qualified," and "under-utilization" are flung about, and defined in strange and tortuous ways; and images are conjured up of either massive benefits conferred on blacks and females at the expense of white males, or cynical evasions of "affirmative action" programs by employers whose discriminatory practices are ignored by inept or cowardly government agencies. For the academic world, there is the additional image of an "old-boy network" through which professors are hired by their cronies. But despite an abundance of horror stories, there has been pathetically little analysis establishing the general conditions in the academic world before or after "affirmative action."

To make these intricate and emotionally charged issues manageable, it is necessary to 1) distinguish the basic concepts and legal rationale of "affirmative action" from the many specific laws, regulations, and practices that have developed under that label; 2) measure in some general terms the magnitude and severity of the problem that was intended to be solved or ameliorated by "affirmative action" programs; 3) consider the actual results achieved and general trends set in motion by such programs; and finally 4) weigh

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the implications of "affirmative action" policies both for those directly affected and for the general society.

Undoing the past

The general principle behind "affirmative action" is that a court order to "cease and desist" from some discriminatory practice may not be sufficient to undo the harm already done, or even to prevent additional harm as the result of a pattern of events set in motion by the prior illegal activity. This general principle goes back much further than the civil-rights legislation of the 1960's, and extends well beyond questions involving ethnic minorities or women. In 1935, the Wagner Act prescribed "affirmative action" as well as "cease and desist" remedies against employers whose anti-union activities had violated the law. Thus, in the landmark Jones and Laughlin Steel case which established the constitutionality of the Act, the National Labor Relations Board ordered the company not only to stop discriminating against those of its employees who were union members, but also to post notices to that effect in conspicuous places and to reinstate unlawfully discharged workers, with back pay. Had the company merely been ordered to "cease and desist" from economic (and physical) retaliation against union members, the *future* effect of its *past* intimidation would have continued to inhibit the free-choice elections guaranteed by the National Labor Relations Act.

Racial discrimination is another obvious area where merely to "cease and desist" is not enough. If a firm has engaged in racial discrimination for years, and has an all-white work force as a result, then simply to stop explicit discrimination will mean little as long as the firm continues to hire by word-of-mouth referrals to its current employees' friends and relatives. (Many firms hire in just this way, regardless of their racial policies.) Clearly, the area of racial discrimination is one in which positive or affirmative steps of *some kind* seem reasonable—which is not to say that the particular policies actually followed make sense.

Many different policies have gone under the general label of "affirmative action," and many different organizations—courts, executive agencies, and even private organizations—have got involved in formulating or interpreting the meaning of that term. The conflicting tendencies and pressures of these various institutions have shifted the meaning of "affirmative action" and produced inconsistent concepts at the same time. There is no way to determine *the*

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meaning of "affirmative action." All that can be done is to examine the particulars—the concepts, intentions, and actual effects.

In a society where people come from a wide variety of backgrounds and where some backgrounds have been severely limited by past discrimination, the very definition of equality of opportunity is elusive. For example, a seniority system in a company which previously refused to hire minority individuals means that present and future discrimination occur because of past discrimination. A Court of Appeals decision struck down such a system on the grounds of its *current* discriminatory effect. In another case, the Supreme Court struck down a mental test for voters in a community with a long history of providing segregated and inferior education for Negroes. Again, the rationale was that the case involved *present* discrimination, considering the past behavior; but this case touches the crucial question of what to do when the effects of past discrimination are incorporated in the current capabilities of individuals. Is equal opportunity itself discriminatory under such circumstances? If so, is anything more than equality of treatment justifiable under the 14th Amendment and corollary statutes and court rulings? As important as the question of whether a legal basis exists for any compensatory or preferential treatment is the question of who should bear the inevitable costs of giving some citizens more than equal treatment. A question may also be raised as to whether such treatment really serves the long-run interests of the supposed beneficiaries.

The legislative history of the Civil Rights Act of 1964 shows that many of these concerns and dilemmas were present from the outset. Senator Hubert Humphrey, in helping to steer this legislation through Congress, attempted to meet criticism by pointing out that the Act "does not require an employer to achieve any kind of racial balance in his work force by giving any kind of preferential treatment to any individual or group." He said that there must be "an intention to discriminate" before an employer can be considered in violation of the law, and that the "express requirement of intent" was meant to prevent "inadvertent or accidental" conditions from leading to "court orders." Senator Joseph Clark, another supporter, made it clear that the burden of proof was to be on the Equal Employment Opportunity Commission (EEOC) to "prove by a preponderance" that a "discharge or other personnel action was because of race." Clark added flatly: "Quotas are themselves discriminatory."

Congress also faced the difficult question of what to do about groups whose historic disadvantages left them in a difficult position to compete on tests with members of the general population. Sen-

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ator Tower of Texas cited, as an example of what he was opposed to, a case in Illinois where a state agency had forced a company to abandon an ability test which was considered "unfair to 'culturally deprived and disadvantaged groups.'" Senator Case replied that "no member of the Senate" disagreed with Tower concerning such examples, and Senator Humphrey affirmed that such tests "are legal unless used for the purpose of discrimination." Humphrey rejected Tower's proposed explicit amendment on this point because he considered it redundant: "These tests are legal. They do not need to be legalized a second time." Senator Case characterized the actions of the Illinois state agency as an "abuse," and said that the Civil Rights Act did not embody "anything like" the principle involved in the Illinois case. Humphrey brushed aside the Illinois case as "the tentative action of one man," which he was sure the Illinois commission as a whole would "never" accept.

The shift in the burden of proof

Despite the clear Congressional intent, expressed by both supporters and opponents of the Civil Rights Act of 1964, the actual administration of that law has led precisely in the direction which its sponsors considered impossible. The burden of proof has been put on those employers whose proportional representation of employees by race or sex is not satisfactory to federal agencies administering that law. The chairman of EEOC has demanded that employer witnesses at public hearings cite "the action taken to hire more minority people." The position of EEOC is that "any discussion of equal employment opportunity programs is meaningful only when it includes consideration of their results—or lack of results—in terms of actual numbers of jobs for minorities and women. . . ." Numbers and percentages are repeatedly invoked to show "discrimination" without any reference to individual cases or individual qualifications—with percentages below EEOC's expectations characterized as "exclusions" or "under-utilization." The notion of qualified applicants has been expanded to mean "qualified people to train"—i.e., people lacking the requirements of the job, whom the employer would have to pay to train. Contrary to the Congressional debates, the burden of proof has been put on the employer to show the validity of tests used, and the notion of "tests" has been expanded to include job criteria in general, whether embodied in a test or not. As for employer intentions, a poster prepared by EEOC includes among 10 true-or-false questions the statement: "An em-

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ployer only disobeys the Equal Employment Opportunity laws when it is acting intentionally or with ill motive"—and the answer to that question is *false*. Despite Senator Humphrey's assurances about "express requirement of intent," legal action can be taken on the basis of "inadvertent or accidental" conditions.

EEOC is only one of many federal agencies administering the Civil Rights Act in general or the "affirmative action" programs in particular. There are overlapping jurisdictions of the Labor Department, the Department of Health, Education, and Welfare (HEW), the Justice Department, the EEOC, and the federal courts. There are also regional offices of all these agencies, which vary significantly in their respective practices. Moreover, when one federal agency approves—or requires—a given practice, following such an approved course of action in no way protects an employer from being sued, on the grounds of following that very same course of action, by another federal agency or by private individuals. Indeed, federal agencies have sued one another under this Act.

Parallel to this development of the interpretation of the Civil Rights Act, and more significant for higher education, has been the elaboration of an Executive Order requiring "affirmative action" by federal contractors. This order is enforced by different federal agencies under the general supervision of the Labor Department. For higher education, the regulating agency is HEW.

The courts have not gone so far as the administrative agencies in forcing numerical "goals and timetables" on employers. Such numerical specifications have typically been invoked by the court only where there has been demonstrable discrimination—not simply "wrong" racial proportions—by the particular employer in question: They are a "starting point in the process of shaping a remedy" for "past discriminatory hiring practices" by the employer to whom the court order applies. In the landmark *Griggs vs. Duke Power Company* case, the Supreme Court included the company's past racial discrimination as a reason why the company could not use tests which eliminated more black job applicants than white job applicants and had no demonstrated relationship to actual job performance. In general, the courts have rejected the notion that "any person be hired simply because he was formerly the subject of discrimination, or because he is a member of a minority group. . . ."

Legal remedies under the Civil Rights Act and related Executive Orders range from "cease and desist" orders, through individual reinstatement or group preferential hiring, to the cutting off of all federal contracts to the offending employer. The latter is a virtual

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sentence of death to any leading research university, whether public or "private," for they are all dependent upon federal money to maintain their competitive standing, and will sustain a massive loss of top faculty without it.

Discrimination in academia

There is little real question that if one goes back a number of years one finds a pervasive pattern of discrimination against minorities in academic employment. This applies not only to blacks and other minorities regarded as "disadvantaged," but also to Jews, who were effectively excluded from many leading university faculties before World War II. The situation with respect to women is somewhat more complicated and will be deferred for the moment. However, the question that is relevant to "affirmative action" programs for both minorities and women is what the situation was at the onset of such programs and how the situation has changed since.

While colleges and universities were subject to the general provisions of the Civil Rights Act of 1964 and to subsequent Executive Orders authorizing cancellation of federal contracts for non-compliance, the *numerical proportions* approach dates from the Labor Department's 1968 regulations as applied to academic institutions by HEW. More detailed requirements—including a written "affirmative action" program by each institution—were added in 1971. The "Revised Order No. 4" contains the crucial requirement that to be "acceptable" an institution's "affirmative action program must include an analysis of areas where the contractor is deficient in the utilization of minority groups and women" and must establish "goals and timetables" for increasing such "utilization" so as to remedy these "deficiencies."

For purposes of establishing a chronology, 1971 may be taken as the beginning of the application of numerical "goals and timetables" to the academic world. The question thus becomes: What were the conditions in academic employment, pay, and promotions as of that date? With respect to minorities in general, and blacks in particular as the largest minority, *virtually nothing* was known about these crucial matters at that point. Assumptions and impressions abounded, but the first national statistical study of black academic salaries was not published until the spring of 1974 by Professor Kent G. Mommsen of the University of Utah. *In short, "affirmative action" programs were going full blast for years before anyone knew the dimensions of the problem to be solved.*

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Nevertheless, it is relatively easy to find out what the situation is in academic employment, for the academic profession is unique in the mountains of statistical data that exist giving detailed information on crucial career factors for individuals. It is a relatively straightforward process to match individuals of similar characteristics—as regards degrees, research publications, experience, etc.—and to determine what pay and promotions differences there are by race or sex. Moreover, each of the major academic fields has long-established ratings of its own departments across the country, so that the crucial *qualitative* dimension of an individual's training or of the employing department can be gauged much more easily than in most other occupations. The American Council on Education (ACE) has made massive surveys covering all these factors, with samples of more than 50,000 academics each, in 1968-69 and in 1972-73—perfect for a "before" and "after" look at the effects of employment "goals and timetables," which were established in 1971 for colleges and universities. In addition, the National Science Foundation (NSF) and the National Academy of Sciences (NAS) have similarly massive samples of data on holders of doctoral degrees, going back for more than a decade. In short, it is easy to get the facts about academics—for those who *want* the facts, instead of the overheated rhetoric and indignant posturing that have become standard procedure in the controversy concerning "affirmative action" in academia.

The situation "before"

What was the situation in academia that the employment "goals and timetables" of 1971 were designed to correct? Blacks as a group earned less than whites as a group, and women as a group earned less than men as a group—and both minorities and women were a smaller percentage of the academic profession than of the general population. This far everyone can agree on the facts. But when seeking *reasons* for these facts, different observers split into warring camps. But there are innumerable facts on file to permit matching individuals on the crucial variables of an academic career, in order to determine how much of the gross racial or sex differentials in employment, pay, and promotion are due to different career characteristics and how much to employer discrimination against equally qualified individuals.

A mere glance at academic career characteristics shows vast differences between blacks or women and the rest of the profession.

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Black or female academics have a Ph.D. less than half as often as the rest of the profession, publish less than half as many articles per person, and specialize in the lowest-paying fields—notably education, the social sciences, and the humanities, with very few being trained in the natural sciences, medicine or law, or other highly-paid specialties. Even if no employer had a speck of prejudice, black and female academics would still have lower pay and promotion prospects. But in the real world, where prejudice obviously exists, how much concrete difference remains when the career characteristics are the same?

Academic salaries in 1969-70 for black academics with a Ph.D. averaged *exactly $62 a year* below that of white academics with a Ph.D. This was before "goals and timetables" were applied to colleges and universities, and makes *no* allowance for the different distribution of black academics by field. On a field-by-field basis, blacks with doctorates sometimes earned less and sometimes earned slightly *more* than white doctorates in the same field:

TABLE I. *Race Differentials Before Affirmative Action (1969-70 Mean Academic-Year Salary of Ph.D.'s)* [1]

	WHITE ACADEMICS	BLACK ACADEMICS	BLACK/WHITE SALARY PERCENTAGE
Natural sciences	$17,225	$15,176	88%
Social sciences	$16,872	$17,527	104%
Humanities	$15,572	$15,034	97%
All fields	$16,677	$16,037	96%

[1] Source: Kent G. Mommsen, "Black Ph.D.'s in the Academic Marketplace," *Journal of Higher Education* (April 1974).

This does not prove the purity of the academic soul. The situation that existed just before "affirmative action" was the result of more than a decade of civil-rights legislation, demonstrations, and changes in American public opinion. "Affirmative action," however, must be judged against the background of the situation that actually existed when numerical "goals and timetables" were applied to colleges and universities in 1971, not against the background of virtually total exclusion of blacks from leading academic institutions a generation earlier. Some proponents of "affirmative action" persistently make comparisons with that earlier era, as if all the anti-discrimination forces of the 1960's had never existed.

The issue of equal "representation" is a little more complicated than the issue of equal pay, and the case of women is somewhat different from that of minorities—but the end results are equally

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clear-cut. If "representation" in academic employment is measured against the "qualified" supply, everything depends upon how "qualified" is defined. Taking the standard academic requirement of a Ph.D. for a long-term career as a tenured professor (though non-Ph.D.'s fill many non-tenured positions), both blacks and women are *over*-represented among academics. Women hold about 10 per cent of all Ph.D.'s, but are more than 20 per cent of the academics. Blacks hold less than one per cent of the Ph.D.'s, but are more than two per cent of the academics. These figures are, of course, nowhere near the population proportions for either group, nor are they any reason for complacency, but they do suggest that the *cause* of "under-representation" is not necessarily employer discrimination. (The complex social processes behind the figures reach back well before the date when the statistics were collected, and extend well beyond the institution at which they were collected.)

Although minorities and women are often lumped together, it is very questionable to lump even minorities together. Orientals have *very* different patterns from blacks, and women are quite different from either. The crucial variable for academic women's careers is marriage. Single academic women with a Ph.D. achieve the rank of full professor *more often* than do other academics with similar years of experience—though married female Ph.D.'s achieve that rank far less frequently. This was true *before* "affirmative action." Moreover, the average 1968-69 academic-year salary of full-time female academics who were never married was slightly *higher* than that of males who were never married (Table II). Indeed a number of

TABLE II. *Sex Differentials Before Affirmative Action (1968-69 Mean Academic-Year Salary, All Academics)* [1]

	MALE ACADEMICS	FEMALE ACADEMICS	FEMALE/MALE SALARY PERCENTAGE
Never married	$11,070	$11,523	104%
Presently married	$13,562	$10,264	76%
Divorced, widowed, etc.	$15,065	$13,176	88%

[1] Source: American Council on Education

measures and indicators show that the basic difference in pay and promotion was between married women and all other persons. The gross "male" versus "female" comparisons are lopsided largely because married women (and especially married women with children) drag down the averages of other women.

It is not difficult to understand why married female academics

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fall so far behind others. Innumerable surveys show that 1) married academic women put more time than married academic men into the home and family; 2) the geographical location of academic couples is usually determined by the husband's career prospects, with little concern for how this affects the wife's career; and 3) women interrupt their careers more often than men, usually for child-bearing or other reasons related to the needs of others. Surveys of academics show that men and women both overwhelmingly agreed that marriage advances a man's career and retards a woman's. Income statistics confirm these beliefs: While academic women who never married have an edge over their male counterparts, married academic men have a huge advantage over married female academics. The situation averages out to a "male" advantage over "females," but this average conceals more than it reveals. What it conceals is that 1) people who are independent do about the same in the academic world, regardless of sex; 2) people with help (married men) do much better; and 3) those who are doing the helping (married women) do worst of all in their own careers. Such a situation may not be just—but it does not result, however, from employer discrimination.

There are some further indications that the location of the problem is the home rather than the work place: low marriage rates and high divorce rates among academic women. Academic women are married less frequently than academic men and divorced several times as often. This tendency reflects more than the general problem for women of combining a career with marriage. Non-academic female Ph.D.'s have higher marriage rates than academic female Ph.D.'s, as do women in other professions. The academic profession is unique not only in the Draconian "publish or perish" rule which demands great amounts of time for research, but also in the geographical isolation of most top research universities. The demands of continuous research are an obvious strain on whoever assumes the primary responsibility for maintaining domestic life—the wife, in most cases. The geographical isolation is a less obvious but very potent force, as well. An academic woman whose husband teaches at Cornell will not have an equally prestigious institution available as a potential employer within a radius of 200 miles (for UCLA the comparable figure would be 400 miles). So her career faces a major setback, barring the happy coincidence that the same institution has an opening for her at the same time that it has one for him—unless her husband considers her career equally important in deciding where to locate, which may be an even more unlikely circumstance.

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If she resigns herself to working at a less prestigious institution nearby, she may be accepting not only a lower salary but also a lesser prospect of developing her own abilities in the environment that such growth requires. While Cornell or UCLA may be unusually isolated, it is rare to have several top-rated research universities within commuting distance of one another. The result is that a married academic woman, equally qualified with her husband, is going to be "under-utilized" unless the couple agree to alternate, or somehow share, the inherent disadvantages of their professional situation —or unless a coincidence rescues them from some hard choices.

The situation "after"

What drastic changes have been wrought by "affirmative action" in the academic world to result in the great outpourings of words and emotions? Practically none, as far as the pay, employment, or promotions of women and minorities are concerned. The ACE data show that blacks were 2.1 per cent of academics in 1968-69 and 2.9 per cent in 1972-73, while women were 19.1 per cent in 1968-69 and 20.0 per cent in 1972-73. These are hardly revolutionary changes. Later data from other studies also show very little change.

Neither are there dramatic changes in the salaries of minorities or women relative to other members of the academic profession. A tabulation of ACE data shows a black/white salary differential of $640 per year for academic year 1972-73 in favor of whites ($16,677 versus $16,037); but blacks usually earn slightly more than whites on a field-by-field basis, with degrees and publications held constant. This is very similar to the statistical results before "affirmative action." For women, NAS data show that full-time, continuously employed female doctorates in the natural sciences and the social sciences earn identical percentages of the incomes of male doctorates in these fields in 1970 and in 1973.

What is a drastic change is that the *process* of academic hiring has become a bureaucratic nightmare, regardless of who ends up being hired. A university's "affirmative action" report to the government typically weighs several pounds—and may still be rejected for not being detailed enough! The University of Michigan spent $350,000 for compiling statistics alone. HEW prescribes elaborate and arbitrary formulas for determining the "available supply" of "qualified" applicants—formulas which defy economics, statistical theory, or logic. Moreover, the long-standing practice of having a professor's qualifications judged by other specialists in his field is

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increasingly being overturned by academic administrators who now either take the decision out of the hands of academic departments or put the departments under heavy pressure to act in a way that will preserve the institution's access to federal money. This need not involve hiring a minority or female faculty member—and usually does not, as the statistics indicate—but does involve a legalistic and bureaucratic manner of recruiting, screening, and evaluating candidates in order to generate enough paperwork to show "good faith efforts" to meet numerous "goals and timetables" for minority and female employment. These charades take the place of meeting quotas which no one seriously expects to be met. For example, if American colleges and universities were to hire every black Ph.D. in the United States, active or retired (or indeed, living or dead) —a 100 per cent drain from industry, government, and other institutions—the result would still be less than three black faculty members per institution. Given the hard facts of the situation, it is not surprising that colleges and universities do not fulfill their employment "goals," but instead go through a costly and demoralizing process called "good faith efforts"—a process equally embittering to supporters and opponents of "affirmative action." This produces few jobs and much anguish.

An additional source of bitterness is the current academic retrenchment in hiring, brought on by financial conditions. This retrenchment means that many aspiring academics would necessarily have had their career hopes disappointed, regardless of "affirmative action." Now, when a hundred white male applicants are rejected, they can all blame it on one or two minority or female academics who were hired—even though over 90 per cent of the white males could not have been hired anyway, and there are probably 10 or 20 other white males hired for the one or two "affirmative action" professors. But administrators can, of course, *tell* rejected applicants that they lost out because of "affirmative action," whether it is true or not, because that may be easier than telling them the real reasons. Again, the situation has high potential for bitterness for both the supporters and the opponents of "affirmative action."

"Qualifications"

Among the many crudities of the "affirmative action" program is the notion of "qualified" applicants. Given the enormous range of standards among the thousands of American colleges and universities, virtually anyone who has been to graduate school is "qualified"

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to teach somewhere, while only a small fraction of the Ph.D.'s are "qualified" to teach at the top institutions. In the real world, the question of qualifications is the question whether an individual's career characteristics—degrees, publications, etc.—match those sought by the employing institution. If a university does not hire someone, that does not mean either that the candidate is "unqualified" to be in the profession or that the university is being unreasonable or discriminatory. But, obvious as this is, the government defines "under-utilization" as the existence of a lower representation of a given group among employees than the representation of that same group in the "available" supply of "qualified" people. Moreover, the meaning of "qualified" has been stretched to mean "qualified to be trained," and the "available" supply includes women who no longer work (usually because of their husbands' prosperity).

The government's crude concept of a pool of "qualified" individuals overlooks the basic fact that academic departments in general do not hire faculty in general. Departments hire specialists in different areas of their respective fields. An economics department will seldom be in the market for "an economist" or even a "qualified" economist. They will be looking for an international-trade theorist familiar with econometrics, or a labor economist knowledgeable about manpower-training programs. Statistics on the racial or sex composition of the economics profession are irrelevant. Women, for example, are distributed very differently among the specialties in economics than are their male counterparts. What matters is the pool of qualitatively comparable people in the specialty, which may be only a half-dozen for any given department at a given time. Schools at the top of the prestige rankings are unlikely to have even this many candidates actually available to move at a given time—although hundreds lacking the qualifications may submit resumés if the position is advertised. Moreover, it will be virtually impossible to draw up in advance a list of vacancies to be filled in the years ahead—as the government would like—for that means predicting which members of a department are likely to leave.

The "old-boy network"

Universities have long relied on the expertise of their respective departments in gauging job qualifications, rather than have administrators pretend to be experts on every field from art to zoology. The department, in turn, often has had to canvass the opinions of trusted colleagues at other institutions to develop a balanced assess-

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ment of candidates, or to suggest likely prospects. Since no one department is in touch with the thousands of other kindred departments in the country, each is limited in its information network to a relative handful of similar departments for candidates about whom it can get the kind of detailed and reliable information it wants. This situation has led to charges of an "old-boy network" through which jobs are given to cronies, and in particular to the charge that minorities and women, as outsiders, are institutionally disadvantaged by the very existence of the network. As in so much of the "affirmative action" controversy, however, in this charge there is a premium on rhetoric, preconceptions, and insinuations, and a virtual moratorium on facts.

Two considerations must be separated: 1) the necessity and value of the informal communications network as a recruiting channel in general, and 2) the extent to which minorities and women are outside this network. The first is a large subject in itself. Long before "affirmative action," there were numerous attempts to replace the informal networks with a more "rational" system of academic hiring —with "rational" being used here in the usual sense of something plausible to those unfamiliar with the intricacies of the situation. It is significant that all these attempts at "rational" hiring systems failed miserably, in terms of the reported dissatisfaction of both employers and employees and their observable unwillingness to continue investing time in alternative systems. The more relevant question for "affirmative action" is whether minority and female academics are outside the recruiting channels, which are used especially frequently by top-rated academic institutions, and which are especially important at the beginning of an individual's academic career —before there has been time to establish a scholarly reputation independently of this informal network. The fact is that women receive their Ph.D.'s at the top universities—*within* the "old-boy network"—a higher percentage of the time than men. A comprehensive survey by Professor Kent Mommsen found the same to be true of blacks, with more than half of all black Ph.D's coming from just 10 universities (mostly top-ranked institutions), compared to 37 per cent of all white Ph.D.'s being products of the 10 most frequent Ph.D.-granting institutions. The ACE sample, with different definitions, indicates that a higher percentage of white academics than of black academics received their Ph.D.'s from top-ranked institutions (29 per cent vs. 22 per cent). In any case, the hard facts show nothing like the exclusion of women and blacks from the "old-boy network" suggested by the prevailing rhetoric. It is significant that

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the purveyors of such rhetoric have found it unnecessary to supply any supporting evidence.

The problems of minorities

With all the caveats about "qualifications," it is still useful to get a general view of the career characteristics of minorities and women. The ACE data permit the inclusion of Orientals so that "minority" need not be synonymous with "black," as it so often is, because of relatively more abundant statistics on the black population compared with Mexican-American, Puerto Ricans, native American Indians, and other ethnic minorities.

The data in Table III show both the salary edge of white academics over blacks, and also the *reason* for that edge—a different distribution among various qualification brackets, rather than an edge within those brackets themselves. Blacks, in fact, have the salary edge over whites within three out of the four brackets. These

TABLE III. *Mean Academic-Year Salary (1972-73) of Full-Time Faculty*[1]

	WHITE ACADEMICS	BLACK ACADEMICS	ORIENTAL ACADEMICS
"Distinguished" or "strong" Ph.D.	$17,991 (11%)	$20,399 (4%)	$18,235 (16%)
Lower-ranked Ph.D.	$17,414 (14%)	$19,014 (6%)	$17,035 (27%)
Unranked doctorates	$18,179 (12%)	$20,499 (8%)	$16,724 (17%)
Less than doctorate	$15,981 (62%)	$15,195 (82%)	$12,272 (41%)
All faculty	$16,677 (100%)	$16,037 (100%)	$15,419 (100%)

[1] Source: American Council on Education

statistics also undermine the belief that "incompetent" blacks are generally earning "exorbitant" academic salaries because of "affirmative action." Actually it is the most qualified blacks who have the greatest edge over their white counterparts, while the least qualified blacks do not earn as much as the least qualified whites. This is even more apparent when these statistics are further broken down according to publication records: Black academics who have published five or more scholarly articles average about $3,000 per year more than white academics who have published five or more scholarly articles, while black faculty who have published nothing earn slightly less than white faculty who have published nothing. Insofar as this is attributable to "affirmative action" pressures, it suggests that that program has had its greatest financial impact on those blacks who needed it least.

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The situation for Orientals is very different. Oriental faculty earn slightly less than black or white faculty, but are better qualified than either—whether measured by the percentage holding a Ph.D., the proportion of Ph.D.'s from top-rated departments, or the number of publications per person. More than 40 per cent of all Oriental faculty had published five or more scholarly articles, compared with 31 per cent for whites and 12 per cent for blacks.

The case of Oriental faculty illustrates the pitfalls in trying to determine the level of discrimination from the amount of gross differentials. There are minor salary differentials among all three racial groups, but these small differentials represent substantial underpayment of Oriental faculty relative to others with the same qualifications in the same fields. Orientals are in the high-paying natural sciences to a greater extent than either blacks or whites, so that they would tend to have the highest salaries overall, if everyone were paid the same within each field. But Orientals are almost invariably the lowest paid, by two or three thousand dollars per year in every field for any given level of degree and any given number of articles published. For example, Orientals in the natural sciences with five or more articles published averaged $17,852 in salary in 1972-73, compared to $19,469 for whites and $20,640 for blacks with these same qualifications. In the humanities, Orientals with five or more articles earned nearly $2,000 a year less than blacks and nearly $4,000 a year less than whites with the same publications records. In the social sciences the Orientals with the most publications earned $4,000 per year less than whites and $8,000 less than blacks in the same category. In all three fields, Orientals had Ph.D.'s more often than blacks or whites, and had these Ph.D.'s from higher-ranked departments than the other two groups. In short, just as substantial pay differentials overall do not prove discrimination—because groups fall in different qualifications categories—so an absence of large gross differentials between groups does not prove an absence of discrimination, if one group has large unrewarded qualifications differentials.

The complications of marital status make it impossible to directly compare women with men in the same way. However, a further breakdown of the data already cited in Table II shows that "never married" women with publications earned slightly more ($293 annually) than "never married" men in top-rated institutions, and slightly less ($114 annually) in other institutions; and "never married" women without publications in unranked institutions earned a hefty 45 per cent more than "never married" men in the same

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category. This lends support to the belief that many able women end up in non-research institutions because they prefer teaching, and are therefore superior to the men who more often end up in such places simply because they could not do better. It also indicates that when women do better than men, they get paid more than men.

The preference of women for teaching over research is not only significant in itself, it also highlights the crucial element of individual *choice* which is routinely ignored in syllogistic arguments which go directly from statistical "under-representation" to "exclusion" or "discrimination." Blacks, too, exercise individual preference and choice. The Mommsen study found that black faculty were unwilling to move from their present positions—mostly in black colleges—for less than a $6,000-per-year raise. They are hardly standing with their noses pressed against the windows of universities from which they are "excluded."

The negative effects

If the "affirmative action" program were merely inane, futile, and costly, it might deserve no more attention than other government programs of the same description. But it has side effects which are negative in the short run and perhaps poisonous in the long run. While doing little or nothing to advance the position of minorities and females, it creates the impression that the hard-won *achievements* of these groups are *conferred* benefits. Especially in the case of blacks, this means *perpetuating* racism instead of allowing it to die a natural death or to fall before the march of millions of people advancing on all economic fronts in the wake of "equal opportunity" laws and changing public opinion. During the 1960's—*before* "affirmative action"—black incomes in the United States rose at a higher rate than white incomes. So too did the proportion of blacks in college and in skilled and professional occupations—and along with this came a faster decline in the proportion of black families below the poverty line or living in substandard housing. When people ask why blacks cannot pull themselves up the way other oppressed minorities did in the past, many white liberals and black "spokesmen" fall right into the trap and rush in to offer sociological "explanations." But there is nothing to explain. The fact is that blacks *have* pulled themselves up—from further down, against stronger opposition—and show every indication of continuing to advance.

While this advance is the product of generations of struggle, it

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accelerated at an unprecedented pace in the 1960's, once the worst forms of discrimination had been outlawed and stigmatized. Black income as a percentage of white income reached its peak in 1970—the year *before* numerical "goals and timetables." That percentage has gone down since. What "affirmative action" has done is to destroy the legitimacy of what had already been achieved, by making all black achievements look like questionable accomplishments, or even outright gifts. Here and there, this program has undoubtedly caused some individuals to be hired who would otherwise not have been hired—but even that is a doubtful gain in the larger context of attaining self-respect and the respect of others.

The case of women is different in many factual respects, but the principle is the same. Unfortunately, there is much fictitious "history" used to apply the "minority" concept to women. The fact is that women were a higher proportion of college faculty, Ph.D.'s, M.D.'s, people in *Who Who's*, etc., generations ago than they are today—and female incomes in the nation as a whole were a higher percentage of male incomes then than they are now. While many factors may have influenced their relative decline over the decades, that long decline paralleled a rise in marriage rates among educated women and a rising birth rate among women in general—the "population explosion"—and the recent upturn for women has followed a reversal in these trends that had tied them to domesticity. In the case of women, as in the case of minorities, this all happened *before* "affirmative action" and its numerical "goals and timetables." Their achievements were also made to look like the government's gift.

Who were the gainers from "affirmative action" quotas? Politically, the Nixon Administration, which introduced the program, gained by splitting the ethnic coalition which had elected liberal Democrats for decades. Blacks and Jews, for example, were immediately at each other's throats, after having worked together for years on civil-rights legislation and other socio-political goals. Whether the architects of Watergate had any such Machiavellian design in mind is a question on which each can speculate for himself. Certainly, the clearest continuing beneficiaries are the bureaucrats who acquired power, appropriations, and publicity from their activities, and who have stretched the law far beyond any Congressional intent. Nothing in the Civil Rights Acts or the Executive Orders authorizes quotas by any name, and both the Congressional debates and the specific language of the law forbid them. But the boldness of the various agencies who interpret and administer "affirma-

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tive action," and the reluctance of courts to overrule administrative agencies, has permitted the growth of an administrative empire serving itself in the name of serving the disadvantaged.

The semantic evasions and political zigzags which have marked the evolution of "affirmative action" programs are symptomatic of the confused thinking that exists in this area. Central to this confusion is a failure to understand the tragic situation of disadvantaged groups—tragic both in the sense of involving unhappy circumstances and in the classical sense of involving a genuine conflict of rights, not merely a conflict between the "good guys" and the "bad guys."

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The undelivered health system

PAUL STARR

No one who has considered the history of medical care in the United States, particularly over the last several decades, can fail to be impressed by the tenacity of private physicians. While bureaucratic organizations have invaded nearly every corner of the economy, the medical profession has continued to prosper for the most part in independent, fee-for-service practice. Until recently, it had successfully resisted almost every form of external constraint, discipline, or regulation. Even when the profession lost its long battle against Medicare in 1965, it succeeded in having the legislation expressly state that no changes in the organization of medicine were intended.

It appeared to be a remarkable political shift, therefore, when only six years later a Republican Administration adopted the encouragement of "health maintenance organizations" (HMO's) as a central part of its health policy. This seemed to signal a historic departure from previous initiatives in the medical sector. Earlier administrations had advocated changes in the financing of health care, but none had dared to challenge the way it is actually delivered. HMO's are programs that provide a wide range of hospital and medical services to a defined group of subscribers in return

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for an annual premium. They historically have been favored, especially in the form of prepaid group practice, by labor and the left because they guarantee direct services rather than cash indemnity, and provide more comprehensive coverage than health insurance. Considerable evidence indicates that HMO's bring about substantial reductions in overall medical costs. Because the prepaid plans are "at risk" for the annual costs of providing health care, they reverse the traditional incentives in the fee-for-service sector to do unnecessary surgery, prolong hospitalization, and construct unneeded facilities. It was this internal incentive toward cost control that attracted the Administration's interest.

The concern of the federal government for reorganization of the health care system can be traced directly to its assumption of an increasing proportion of the nation's medical costs in the years after the enactment of Medicare and Medicaid. Structural change in the health system, once thought to be a hopelessly quixotic venture, has now become a fiscal necessity. Two things render it particularly urgent for the immediate future. One is the unmistakable sense that national health insurance, in some form, is politically irresistible. The other is the understanding that such a program would be highly inflationary under the present medical system, increasing the costs of services that have long ceased to make much of a difference in the actual health of the population. On the one hand, the public demands financial relief for personal medical expenses. On the other, many of those who make public policy believe that financial relief in the form of national health insurance will only add to the burden of cost for the society as a whole—hence the pressure for structural reforms that will permit the satisfaction of public demands at a level the nation can reasonably afford.

Broadly speaking, two strategies are available. The government can tighten and expand the regulation of existing institutions, or it can promote the development of new institutions and arrangements with internal incentives to control costs. HMO's are the principal expression of the second approach. Much of the support for HMO's has come from people who have seen them as a way of avoiding a regulatory solution, or who have held that regulation would be no solution at all.

For a time, the endorsement of HMO's by both Senator Kennedy and President Nixon, and the general support that the HMO idea commanded from virtually every direction except that of the American Medical Association (AMA), seemed to ensure a substan-

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tial commitment from the federal government. Only a few years later, however, while HMO's in various forms continue to grow in communities around the country, they no longer represent a major element in federal health policy. Politically, they have fallen victim not to new arguments or new evidence, but to a mixture of perseverance among their opponents, overzealousness among their friends, special pleading in Congress, and indifference within the Administration. Out of these influences has come internally incoherent legislation, presumably intended to stimulate the development of prepaid plans, but in fact something of an impediment to their growth. The original purpose of the HMO strategy, which was to create self-regulating institutions and thereby minimize federal involvement, has been utterly frustrated by the most elaborate regulation imposed by Congress on any part of the health system. Federal spending in the area has proved to be inconsequential. A state program in California to move Medicaid beneficiaries into prepaid health plans has been riddled with scandals. In the rest of the country, HMO's have proliferated in significant numbers, mostly without federal assistance—at last count, there were 179 nationwide, up from only 37 in 1970—but the future of many of the new plans is problematic. (Total national enrollment, growing at about 10 per cent annually, stands at around 5.5 million, most of which is still concentrated in older programs, like the Kaiser health plan.) While some of these troubles may be temporary, they come at a time when decisions of long-range consequence for the health sector are being made. They are also suggestive, in a more general way, of the difficulties in changing an industry as resilient and politically resourceful as medical care.

Unplanned social experiment

Comprehensive prepaid plans have long encountered vigorous disapproval from the medical profession. Beginning in the 1920's, the AMA not only opposed federally sponsored health insurance, but insisted as well that private health plans, in return for prepayment, offer only cash reimbursement rather than direct services. The AMA also originally fought to keep hospital insurance from embracing physicians' services—hence the independent development of Blue Cross, which the hospitals controlled, from Blue Shield, controlled by the medical societies. The AMA was suspicious of group practice, which some of its members considered little more than "organized fee-splitting."

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Nothing was more abhorrent to the AMA than the combination of all these elements—physicians' services and hospital care, included in a single direct-service plan, together with group practice and group prepayment. When a health cooperative was formed during the Depression to serve farmers in western Oklahoma, the local medical society turned against the leading physician involved, tried to take away his license, and sought to discourage others from joining him. As prepaid plans sprouted in other areas of the country, they were met with blacklists, denials of hospital privileges, and accusations of unethical practice. Finally, in a case involving attacks on the Group Health Association of Washington, D.C., the Supreme Court in 1943 found the AMA guilty of violating the Sherman Antitrust Act.

But in spite of this and other defeats in the courts, the medical societies succeeded in persuading a majority of the states to pass laws effectively barring prepaid group practice. Only in a few areas of the country—particularly along the Pacific coast and through the Northwest, as well as in a few union strongholds in the East—were prepaid plans able to develop. Inadvertently, these few programs became social experiments for the whole country.

The plans took various forms: consumer cooperatives, like the Group Health Cooperative of Puget Sound in Seattle, which now has around 200,000 members; physician-sponsored plans, like the Ross-Loos Medical Group of Los Angeles, with over 120,000 now enrolled; and nonprofit corporations, like the immense Kaiser Foundation Health Plan, with 2.8 million members in California, Oregon, Hawaii, Colorado, and Ohio. A few, like the Kaiser plan and the Seattle cooperative, financed and constructed their own hospitals, employed physicians full time, and grew into comprehensive, virtually self-sufficient medical systems. Less unified programs, like the Health Insurance Plan (H.I.P.) of New York, which has about 780,000 members, depended on community hospitals and independent medical groups with part-time physicians—an arrangement that, in H.I.P.'s case, has proved much less satisfactory.

Almost all of the plans experienced severe problems in their early years, particularly in attracting capital and sustaining initial operating losses. Prepaid group-practice plans, by their nature, require a large initial investment in facilities and staff, and are generally self-sustaining only when their enrollment reaches 20 or 30 thousand. This usually takes a few years, and sometimes longer. In the meantime, they often have to maintain some fee-for-service practice to stay afloat.

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From "socialized medicine" to "corporate reform"

However, once the plans hurdled the initial barriers—and many did not—they compiled a record that began to impress increasing numbers of people. The original motivation in forming them had been primarily to improve access to care (particularly for preventive purposes), to check the unpredictable economic consequences of illness for families, and to raise the quality of care through group practice. But from repeated studies it became evident that prepaid group practice, compared with Blue Cross and commercial insurance, also had a dramatic effect in reducing medical costs. The principal factor appeared to be much lower rates of hospitalization due to the removal of incentives for unnecessary surgery, the ability to control the total number of available beds, and the capacity to shift procedures out of the hospital to less expensive ambulatory settings (which, under many insurance policies, would mean loss of coverage). There also seemed to be reduced administrative costs because of the elimination of individual billing, claims review, and other paperwork, and possibly some economies of scale.

Estimates of these savings vary, depending on the bases of comparison, and are disputed on the grounds of differences in the populations compared and the elusiveness of "out-of-plan" expenditures, but various studies have taken these into account and the savings remain substantial. A net reduction of 20 per cent in overall costs is thought to be a fair estimate.[1]

These savings took on added importance with accelerating increases in medical costs in the fee-for-service sector, particularly after the passage of Medicare and Medicaid in 1965. In the course of the 1960's a remarkable reversal in attitudes toward prepaid group practice took place. An idea that had long been identified with the left as a means of extending and guaranteeing health care was gradually taken over by cost-minded enthusiasts of the free

[1] In one of the more interesting comparisons, *Fortune* at one point requested actuaries at two insurance companies to determine what their premiums would be if their policies covered all the services that typical HMO's provide. Connecticut General calculated that a single individual would pay 27 per cent more and an average family 54 per cent more for insurance than they would for membership in an HMO. Northwestern International came up with similar figures. "Both companies," *Fortune* reported, "attributed the lower cost of HMO plans to organizational efficiencies and fewer hospital admissions." For a review of the literature on the costs, as well as on the quality of care, patient satisfaction, and other issues, see Milton I. Roemer and William Shonick, "HMO Performance: The Recent Evidence," *The Milbank Memorial Fund Quarterly (Health and Society)* (Summer 1973), pp. 271-317.

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market. Prepaid plans, rechristened HMO's, would bring health care expenses under control by introducing innovative management and restoring competition. The "socialized medicine" of one era became the corporate reform of the next. Its new advocates—at the Committee for Economic Development, in the pages of *Fortune*, among Ronald Reagan's aides, and within the Nixon Administration—endorsed the idea in terms that left some of its old friends surprised, elated, and appalled, all at once.

This political redefinition of prepaid health care as a cost-saving measure—the substitution of a rhetoric of competition and rationalization for a rhetoric of cooperation and mutual protection—has cost the idea some of its traditional support on the left, and perhaps some of the commitment and passion it formerly evoked. This change, however, is not peculiar to the history of prepaid medical plans. A general process has occurred in the politics of medical care that might be called the political integration of reform: Ideas that developed among liberal and radical critics of the medical profession, hospitals, health insurance, and the drug industry increasingly have been taken over and recast by the government. This process of assimilation reflects an underlying change: With the growth of federal health insurance programs, the economic problems to which the left was responding have become the economic problems of the government.

But changes in the substance of ideas have accompanied changes in their sponsorship. The term "health maintenance organizations," introduced with premeditated ambiguity around 1970, was deliberately elastic, so as to incorporate not only prepaid group practice, but also what have variously been called "independent practice associations" or "comprehensive medical care foundations." While these are also prepaid health plans, they have no actual facilities of their own, and exist only as financial entities which receive prepayments from subscribers and then reimburse independent physicians and hospitals on a fee basis. The advantage over prepaid group practice is a much wider choice of physicians, since all doctors in the community can belong; the disadvantage is diminished organizational control over the quality of care, accessibility, and costs, though foundations do exercise some oversight, particularly through their reimbursement function. The record of the foundations in containing costs, while showing some reductions compared with Blue Cross/Blue Shield and commercial insurance, is decidedly not so strong as that of the group-practice plans. Moreover, a number of supporters of HMO's, like Clark

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Havighurst of Duke Law School, a free-market advocate, maintain that the foundations are anti-competitive and would, if challenged, be found to violate anti-trust statutes. Nonetheless, because they are more acceptable to physicians than prepaid group practice, the foundations have been backed by others who see them as a transitional form en route to the more highly organized systems like the Kaiser plan. In the last few years, intermediate structures, combining elements from the group-practice and foundation plans, have proliferated in bewildering variety, suggestive of the adaptability of the HMO concept to diverse economic interests and political environments.

Autonomy and accountability

In public discussion, the main argument for HMO's—adduced, for example, by President Nixon in his health message in 1971—was that they would find it in their interests to keep their members healthy. This was something of an oversimplification. Health is only in minor degree the product of medical care, no matter how sophisticated; it is much more the product of environmental, genetic, and cultural factors. The primitive state of preventive medicine simply does not provide the means for maintaining health that seemed to be implied in the name "health maintenance organization"—a sobriquet that has stuck all too firmly in a society that already calls sickness insurance "health insurance" and death insurance "life insurance." The real argument for HMO's has always rested not so much on the idea of "health maintenance" as it has on the idea of organization. "We simply feel," Elliot Richardson told a Congressional committee when he was Secretary of the Department of Health, Education, and Welfare (HEW), "that we are more likely to get a rational and economical delivery system by focusing the responsibility for all costs . . . in one organization than we can ever get if these are fragmented and separately accounted for." This concentration of responsibility is also the reason that unions prefer to deal with prepaid plans. It opens up the full range of questions about the actual delivery of medical care to collective bargaining. These questions are inaccessible when dealing with an intermediary like Blue Cross. The same logic applies to consumer control. The concentration of responsibility for comprehensive services in a single organization creates a context for the exercise of consumer influence that simply does not exist when responsibilities are diffused among large numbers of practitioners,

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hospitals, and other institutions. No matter who is the purchaser of services—the government, unions, or consumers—the concentration of functions in an HMO enhances the potential for accountability.

A concentration of responsibilities is also a concentration of liabilities. The HMO is compelled to look much more critically at the costs of manpower, facilities, equipment, and drugs than are existing institutions, which can pass on inefficiencies through cost-plus reimbursement formulas. The purpose of creating HMO's is not only to alter the consumption of medical resources, but also to introduce some rationality into adjacent industries, like the pharmaceuticals, which have long profited from the absence of any effective countervailing power. This may be one of the more important effects of HMO's, yet it is usually ignored in the more narrowly gauged comparisons with the fee-for-service sector.

The objective in bringing physicians into an organization responsible for the total costs of services, as Victor Fuchs points out in his book *Who Shall Live?*, is that they are the ones who ultimately control the larger part of expenditures by determining "the volume of surgery, the number of hospital admissions, the length of stay in the hospital, the number and type of prescriptions." As Fuchs notes, some strategies for containing medical costs aim at making patients more cost-conscious through deductibles and coinsurance, but it is ultimately the cost-consciousness of the physicians that counts. Other strategies call for mechanisms to review doctors' decisions. But trying to regulate physicians' behavior, after the fact, at a remote and secondary level, is likely to be much less effective than changing their incentives and environment.

The attractiveness of internal incentives is that they minimize the need for the second-guessing that characterizes regulation. The fundamental aim of the HMO strategy has been not only a concentration but also a localization of responsibility. Rather than encourage central direction and regulation of the health system, it has sought to promote autonomy and diversity within it. Both those who have looked to competition among HMO's as a creative and restraining force and those who have seen them as vehicles for direct consumer control have been concerned with developing alternatives to a centrally managed health bureaucracy. A regulatory system, instead of encouraging innovation, might tend to fix things in place, particularly if it were captured by regnant institutional interests. The HMO strategy was aimed at creating a system of relatively autonomous organizations that would have a

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capacity both for adaptation under different conditions and for evolution over time.

The unrealized expectations

The Administration's initial plans for HMO's, after the President's endorsement in 1971, called for more than 1600 programs in operation by 1980, with 20 per cent of the public enrolled, but enthusiasm and ambitions soon wilted before the immense structural and political barriers to innovation in the health industry. No upheaval of the sort envisioned could have been accomplished except by encroaching on the share of the market held by Blue Cross/Blue Shield and the insurance companies, and by undermining the independence and power of private practitioners. The doctors felt directly threatened; the insurance industry, on the other hand, saw HMO's as a field for investment and diversification, and possibly as a hedge against a federal take-over of health insurance. The AMA mounted an aggressive campaign against the program, stalling passage of legislation in Congress, and one writer in the *New Leader,* Richard Margolies, has charged that on this issue the President was not immune from the influence of physicians who were contributors to his 1972 campaign. In the spring of that year, an entire round of grants for early HMO projects was cancelled in a sudden reversal of policy, and the momentum lost at that point, according to officials in charge of the program, was never recaptured. The departure from HEW of Secretary Richardson, who had been a strong proponent of the HMO strategy, was a further damaging blow. In any event, instead of adopting the HMO idea as a long-term policy, the Administration decided (and Congress agreed) to adopt it only as a short-run experiment.

Experiments, of course, can be framed in ways that crucially affect their chances of success. Such was the case with the HMO program. The original bills in Congress followed one of two approaches. The first essentially called for high subsidies and high requirements for HMO's; the second for low subsidies and low requirements. Either of these probably would have been more workable than the final legislation, which called for low subsidies and high requirements. These requirements turned out to be so high that in the first full fiscal year of the program, almost half of the modest amount of money available for HMO grants had to be returned to the Treasury unspent, for want of takers. This experience led, in turn, to cutbacks in appropriations, now at such a low

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level (about $18 million a year) that the program's future is dim, even though liberalizing amendments to the original legislation are in sight.

A few figures will illustrate the disparity between the great expectations for the HMO program and its eventual meager dimensions. The original high-subsidy bill introduced by Senator Kennedy would have authorized $5 billion over three years for HMO's (some of it in the form of capitation grants to help low-income people enroll). The authorization dropped to under $1 billion on final Senate approval and fell to $325 million, over five years, when the legislation passed Congress. Actual appropriations, it now appears, will be less than a third of that. Money is disbursed primarily in two forms: grants for feasibility studies, development, and planning, and loans from a revolving fund of $35 million to support initial operating losses. In the first full year, HEW had available $40 million in grants but made use of only $22 million, and therefore was appropriated only $15 million for the current year. This level of expenditure, trivial in terms of the federal budget, means, according to the program's directors, that they can continue to support only 55 of the 157 HMO projects funded the previous year. (A supplemental appropriation could alter this picture.) In early 1972, Secretary Richardson had spoken of creating 1600 new HMO's by 1980; the estimates now are on the order of 70 or 80.[2]

Qualifying provisions

Besides grants and loans, the HMO Act provided a second kind of assistance in the form of access to markets. Though this was

[2] In objection to the program of grants and loans, one might ask why federal money is needed at all. Several considerations argue in favor of assistance. Even the most successful prepaid plans have faced long start-up periods when their enrollment is insufficient to support the broad range of personnel and facilities needed to provide services. While initial planning and operating losses are certain, the prospects for obtaining private capital are limited. The most likely sources—indeed almost the only ones in the past—have been Blue Cross and the commercial insurance companies. The failure of the federal government to provide much seed money for HMO's will mean fewer programs under community and consumer sponsorship; moreover, it will have dangerous effects on the long-term structure of the industry. The same companies that provide insurance will operate HMO's, thus controlling both sides of the market and defeating the goal of increased competition. This seems quite likely to happen, now that the federal grant program has turned out to be of negligible importance. One can anticipate that the divestiture of HMO's from Blue Cross and the insurance companies will loom as a major issue in the future.

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originally not the subject of much discussion in Congress, this provision has now assumed greater importance. Under the provision in the law known as "mandatory dual choice," an employer who has 25 or more workers and who offers them a health benefits plan must include a qualifying HMO (if one exists in the area) as an alternative to health insurance. No employer is required to offer this alternative if he doesn't already offer health insurance, and no employee is obliged to choose an HMO when offered. Still, the provision should be of great use to prepaid plans in gaining access to large groups of potential subscribers. There is, however, one catch: Before an HMO can make use of mandatory dual choice, it must become qualified under the law.

As originally passed, the Act required of qualifying HMO's a relatively broad range of minimum services, a relatively narrow range of organizational characteristics, and an added burden of administrative expense. These requirements, in their combined effect, threatened to make it difficult for programs to offer premiums at a competitive price. Among the basic services mandated by the Act were not merely hospitalization, physicians' services, emergency care, and laboratory and diagnostic services, but also mental health care (up to 20 visits), home health services, family planning, preventive dental care for children, and medical treatment and referral services for alcohol and drug abuse. The qualifying HMO had to provide all of these services to all of its members, regardless of what they might prefer. (There was an additional list of supplementary services an HMO had to offer on an optional basis.) The Act denied a plan the ability to offer lower-priced contracts with more limited benefits to meet the purchasing power of lower-income workers. At the same time, it offered no assistance to such groups to help them afford the high premiums. The result was that qualifying plans would virtually be barred from serving a large segment of the public.

Another set of provisions created further problems of flexibility and cost by imposing on HMO's various rules that no one else was obliged to follow. Qualifying plans were to charge all subscribers the same "community rate," unlike insurance companies which charge higher rates for higher risk groups. HMO's were also to allow "open enrollment" of individuals for 30 days once a year, regardless of their health. This requirement could be waived if a plan was full or could show that open enrollment would jeopardize its financial integrity—a safeguard that offered some comfort to HMO's, but left them with the burden of proof and at the mercy

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of federal officials. Community rating and open enrollment are, no doubt, desirable policies that all insurers should follow as well, but to establish these requirements for HMO's alone was markedly discriminatory.

In other provisions, the Act required qualifying plans to provide elaborate statistical data on their operations and to maintain quality assurance programs stressing "health outcomes" and "process" review. This kind of evaluation research is, at this stage, experimental. The HMO's were being told not only to shoulder the administrative costs of these activities, which none of their competitors would have to undertake, but also to spend research funds to develop the necessary methodology. No one could take such requirements seriously.

Oddly enough, the Act had as one of its stated goals the encouragement of HMO's in rural and medically underserved areas, yet it effectively raised the cost so that the underserved could not afford membership. The legislation was laced with contradictions of this sort. While presumably aimed at making a less costly form of health care available, it seemed to do everything possible to make that alternative more immediately expensive to the consumer.[3]

The burdens of legislation

The immediate impact of the law was damaging. Delays in implementation cost the program support, interest, and enthusiasm. What had once been seen, with excitement, as a means for changing the structure of the health system turned into a minor categorical grant program. The dual-choice provision, which should have given HMO's access to consumers, turned out to have the opposite effect in the short run. Two years passed before HEW was able to issue final regulations putting the provision into effect. While the difficulties in resolving ambiguities and disagreements were genuine, the delay in implementation from December 1973 to November 1975 was discouraging. In the interim, confusion over the implications of the law caused employers throughout the country, including 73 per cent of the *Fortune* 500, to hold up making any arrangements with HMO's, since it was unclear which

[3] Finally recognizing some of these problems, Congress has moved in the past year toward amending the Act. The package of basic benefits will probably be trimmed somewhat, and qualifying HMO's will not have to offer the additional list of supplementary services. Open enrollment may be dropped, and community rating waived for the first five years. A number of other revisions will permit greater organizational flexibility.

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health plans would qualify under the statutes. The result, in many new programs, was sluggish enrollment and also serious financial difficulty.

The complexity and breadth of the law constituted problems in themselves. HEW has been empowered to examine almost every facet of an HMO's activities—personnel, facilities, records, financing. "I don't think we've ever tried to regulate this much of a provider's operation," the director of the Bureau of Community Health Services noted last year. "No other part of the health establishment enjoys this degree of oversight." Were it not for mandatory dual choice, many plans would simply ignore the HMO Act, but they may have no alternative. An employer who has a contract with an HMO is likely to put pressure on it to become qualified under the law. If the plan doesn't, he may later be forced to offer a second HMO that has qualified, and this will mean additional administrative costs. There is also the possibility of a stigma on plans that fail to become qualified, or choose not to do so, even though qualification does not necessarily have anything to do with high standards. To qualify under the law means merely to meet a set of formal requirements stipulated in the legislation; it is not a form of certification. The public has no guarantee that a qualifying plan really provides good medical care. Moreover, the federal office in charge of HMO qualification, with its limited funds, will have a limited capacity to judge the adequacy of programs seeking its approval. Congress first created broad and intricate regulations, then provided little money to carry them out, and thereby ensured future scandals when it is discovered that the government has approved of HMO's that offer inferior services. One has only to wait for the natural history of the program to be played out in the press.

The lacunae in the HMO Act are every bit as formidable as its excesses. There has been no provision for making available to nascent health plans any technical advice or assistance in areas like financial management, organizational development, physician recruitment, and legal support. The role of HEW has been almost entirely passive. It has no authority to lend active assistance to help new plans get started.

The fundamental problem with the law, however, was that it took no account of historical or economic realities. It asked that emerging HMO's undertake at the outset all the services that the most comprehensive plans provide after years of development. It made no allowances for the kind of normal evolution that success-

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ful plans have historically undergone. It placed requirements on HMO's that do not apply to their competitors and that prejudice their chances of survival. It ignored the limited purchasing power available for health services, particularly among lower-income groups. In sum, it made most difficult the form of organization it was ostensibly designed to promote. These problems may be alleviated by legislative amendments, but they will not disappear: The structure of the program has been set, and much damage already done.

"Antagonistic cooperation"?

Why the HMO legislation turned out so badly is a curious question. Congress was certainly forewarned of all the difficulties that subsequently developed. Some who were close to the discussions say that there were considerations beyond the immediate issue—in particular, precedents that would be set for national health insurance, which Kennedy's aides want to be similarly comprehensive. Yet it is hard to imagine that the final form of national health insurance will in any way be influenced by the mandatory benefit provisions in the HMO Act.

The accumulation of special requirements in the legislation seems at least partly the work of lobbying groups and of legislators who had staked out one or another area of health care as their own personal domain. Senator Hughes, a reformed alcoholic, saw to it that the law made treatment for alcoholism and drug abuse a mandatory service. Senators Kennedy and Schweiker were strong proponents of mental health care. Senator Cranston took personal credit for the specific inclusion of family planning and infertility services. Once embedded in the law, such requirements are quite difficult to uproot.

The rigidity of the regulatory provisions in the act seems also to have stemmed from Congressional distrust of the Nixon Administration. "Quite frankly," Senator Kennedy's aide on the HMO bill told me, "we didn't trust the Administration to implement a program in good faith." So they left nothing to chance or discretion. Kennedy's aide ascribes the subsequent failure of the legislation to a "lack of will at OMB and the White House." While not the whole explanation, that is certainly a good part of it. On this issue, both the legislative and executive branches can make a good case for the failings of the other.

Changes within HEW also may have influenced the final form

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of the HMO Act. By the time the final legislation was written, the most credible advocates of HMO's, Elliot Richardson and Jack Veneman, had left HEW. They might have had a moderating influence. In charge of negotiations over the HMO Act was a deputy assistant secretary, Dr. John Zapp, who since has gone to work for the AMA.

Also, the recession had not yet begun, and the difficulties that any new venture would face in a slack economy were not anticipated. Another factor was that, late in the legislative process, scandals erupted in the program in California to move welfare beneficiaries into prepaid plans; some in Congress understandably wanted to avoid repeating those errors through tighter regulation. The most intriguing hypothesis is that there was a kind of "antagonistic cooperation" between some of the strongest advocates of HMO's and some of their most vehement opponents. The advocates wanted HMO's to take on the broadest services and responsibilities and were intent on writing requirements to that effect into the law. The opponents wanted to hamstring the program from the start, and found they could achieve that end the same way. Efforts to amend the law, in the interests of making it more flexible, have encountered opposition from two camps: Senator Kennedy's office and the AMA.

Alternatives to regulation

The California Medicaid experience might, at first glance, seem to offer some confirmation for the view that stringent requirements in the federal law were justified. In an effort to cut welfare costs, the state began in 1972 to award contracts authorizing prepaid plans to give comprehensive care to welfare recipients on a capitation basis. Enrollment was to be voluntary, but the hope was that half of the state's two million Medicaid beneficiaries would sign up within three years. Several dozen new plans sprang up to do business with the state, many of them proprietary operations serving Medicaid clients almost exclusively. Soon there were reports in the press of high-pressured, fraudulent, door-to-door enrollment tactics, substandard services, extremely low ratios of physicians to patients, the use of unlicensed personnel, and irregularities in financing. The United States General Accounting Office (GAO) and the Senate Permanent Investigations Subcommittee have confirmed many of these charges. Several indictments have followed. In some cases, most of the state's funds appear to have been channeled into

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profits of subsidiary firms. In what may be a final irony, the GAO report suggests that the plans may not be saving the state any money.

One study of these "second-generation" prepaid plans has found that the higher the proportion of non-Medicaid clients, the higher the overall quality of services. The state did not originally require, as Congress subsequently did, that plans have from the outset no more than 50 per cent Medicaid and Medicare beneficiaries. The intent of such a provision is to ensure that funded programs be able to attract substantial numbers of consumers who are paying their own way. In effect, these consumers, who are likely to have more alternatives than welfare beneficiaries for obtaining care, act as surrogates for the government in judging the quality of services.

Yet this sort of provision may not be enough to prevent "underservicing" by a prepaid plan. The internal stimulus to economize that characterizes the HMO structure is both useful and dangerous: useful if economy is achieved through improved efficiency; dangerous if it leads to skimping on necessary services. In earlier years, prepaid plans had to be above reproach because of the general suspicion surrounding them, particularly from local physicians. At that time, there was no question of anyone making money; survival was difficult enough. The change in political climate after 1970 and the relatively sudden potential, particularly in California, for making large profits off government contracts and grants have brought into the field people with rather different motivations. Traditions of professionalism and integrity are extremely difficult to maintain under those conditions. The temptation, of course, is to try to regulate them into existence, but that may not be the wisest course.

Members of prepaid plans have three principal means of protecting themselves from an HMO that is more interested in maintaining the organization's health than theirs. The first is the power to leave the program individually or en masse. The second is the leverage that comes through collective bargaining by unions and other subscriber groups. The third is direct membership representation in policy-making.

The power to leave the plan is obviously crucial, yet insufficient to curb abuses. Many subscribers will go for long periods without making any use whatsoever of health services. They may discover the program's inadequacies only months after enrollment, at a time when they are in no condition to do anything about it. At that point, the plan may have already received substantial income on

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their contract. It is often argued that a prepaid health plan cannot afford to neglect its members because such neglect will lead to medical complications and more expensive care later. This assumes, however, that the plan intends first of all to stay in business (in California some dissolved after making a fast profit), and second, to offer adequate services at some future point. A free market in health care is not an adequate defense against undertreatment.

Subscriber group bargaining is, in some respects, a more powerful instrument of self-protection. That the Medicaid recipients in California were enrolled in the prepaid plans on an individual basis, rather than through employee groups, may have deprived them of an important source of leverage. One of the key aspects of the HMO structure is that it creates opportunities for organized consumers to bargain collectively and directly with health care providers; these opportunities generally do not exist in the present fee-for-service market, where patients are usually uninformed about relative prices and differences in the quality of services. The subscriber group is likely to command more information than its members could on their own.

Collective bargaining has its limitations, however. Groups not well represented by unions may not be represented adequately in bargaining over health services. In most American families, for instance, it is the women who take responsibility for the family's health care. But the unions more often represent the men, and consequently may be less aggressive in bargaining on the quality of health services than on the price. The union's concern about health services may also be erratic, vigorous only when contracts are up for renegotiation; and its representatives also may have limited information, particularly if an HMO refuses to disclose it.

The interest of the laity

Direct membership representation offers a way of overcoming some of these limitations. The experience with consumer participation in plans like the Group Health Cooperative of Seattle—where the elected representatives are usually lawyers, architects, social workers, public health experts, university professors, and businessmen—is that the consumer boards tend to interest themselves not in the actual practice of medicine (the canard sometimes raised by physicians), but in the planning of facilities, the range and cost of services, the hours of clinics, waiting time, the availability of related benefits (such as drugs and eyeglasses), and the

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like. The interest of the laity is not to subvert the professionalism of its doctors, but rather to strengthen it against any ill-advised attempts by an overly self-interested management to cut back on medically warranted services.

In the HMO Act, Congress included—wisely, I believe, in this instance—a requirement of one-third membership representation on policy-making boards. This could be strengthened by specifying that the representatives be chosen by the membership. One of the differences between HMO's and other health services is that they have a defined and relatively stable constituency. Consumer representation in regulatory bodies, whether in health care or other areas, tends to consist of designating certain appointees to represent consumer interests, even though there is no actual group of consumers by whom they can be called to account. This sort of representation, where the represented consumer is an abstraction, tends to suggest that there is a single consumer interest, when in fact the interests of consumers are diverse and at times contradictory. The lack of restraint by any concrete constituency can also encourage a tendency to make demands that consciously do not attempt to relate benefits to costs. (The usual assumption, of course, is that the political process as a whole will do that.) In contrast, as members of the plan, representatives in an HMO must personally bear the consequences of their own decisions, both in the costs of premiums and in the services provided. They do not have the option of making exorbitant demands without having to pay the price or, for that matter, inadequate demands without having to face the results. It should be noted, on the other hand, that plans controlled solely by consumers have a more limited ability to attract capital, and may find the recruitment of physicians more difficult. Nor is the mobilization of consensus within the membership necessarily easy.

Of the possible remedies for the kind of problems that developed in California, it seems that subscriber group bargaining and membership representation are likely to be more effective than government regulation. The role of the government should be to look into those areas where the public is least able to make informed judgments on its own, such as technical aspects of the quality of care and the financial soundness of a plan. Here its oversight should be strong; elsewhere, not. If rights to bargaining and representation are maintained, most of the aims of policy can be achieved by rigorous requirements for public disclosure of financial and other data. One of the areas that the government need not regu-

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late is the benefit package. That is precisely the sort of thing on which local bargains should be struck.

The prospects for reform

The whole drift of the federal legislation, however, has been to remove decision-making power from local organizations to Washington. In a case like Seattle's Group Health Cooperative, the members have made deliberate decisions over the years on what services they want and how they want the plan run. In whose interest is it now to withdraw that power from them? "For those pre-existing plans that elect qualification under the act," Dr. Richard Handschin of the Cooperative said in a speech last year, "new markets will probably open up. But costs will go up due to rich benefit packages, and mandated open enrollment and intensified regulations. . . . Benefit provisions will have to be juggled to match the intent of a partially informed and remote Congress, rather than conforming to . . . local desires and experience. . . . No qualifying pre-existing HMO will be the same as it was before. It will be more regulated, more expensive, and less competitive with fee-for-service indemnity services. Perhaps it will be better, that is, if it survives."

The demoralization among developing plans produced by the HMO Act, the confusion among employers and unions over the implementation of mandatory dual choice, and the added complexity that has been created by so many new rules totally out of joint with practical necessity all have had a very damaging effect on the development of new HMO's. Some programs in the planning stage have avoided going operational for as long as possible in the hope that the regulations will be clarified or modified by the time they go looking for subscribers. A few, unfortunate enough to open during this season of political uncertainty and economic recession, have already gone under. Many observers naturally take these failures as signs that the public is not ready for prepaid health care. There is no question that the idea is unfamiliar outside of the West Coast, that it has its limitations, and that it isn't for everyone. But it should be noted that while some of the new programs have been in trouble, others have done quite well, and some of the more established plans have been expanding as rapidly as they can build new facilities and add new staff. The passage of legislative amendments making federal qualification easier and the implementation of dual choice will probably give them a further impetus to growth over the next few years.

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Yet even if HMO's do grow fairly rapidly, it is unlikely they will reach a substantial proportion of the public before the late 1980's or 1990's. As a result, events may simply pass them by. The pressure for a national health service could well become irresistible before that. The one hope that HMO advocates have held out is that the prepaid plans would have an influence far beyond their own membership by virtue of the competition they offered the fee-for-service sector. But this is still speculative; such effects have yet to be felt. The economic advantages of prepaid plans, furthermore, have always been more apparent on the societal than the individual level, where buying health services piecemeal often obscures their total cost. The primary function of HMO's in the long run, in addition to the services they provide their members, may turn out to be as a yardstick for social policy, indicating what kinds of advantages are possible from more systematic organization of medical care.

For the moment at least, regulation is in the saddle, and the crucial question is what long-term effect it will have on the structure of health services. There are several theories about regulation. One is that the regulatory bodies will be captured by prevailing interests and used by them to prevent alternative institutions like prepaid plans from developing. Another is that they will create such a flood of paperwork for the fee-for-service sector that they will actually help HMO's by driving physicians into prepaid arrangements for relief from the administrative side of private practice. A third is that they will hold back cost increases well enough to make more drastic reforms at least fiscally unnecessary. A fourth is that the new regulatory and planning agencies will form the basis of a regionalized national health service. At this point it is impossible to tell what will happen. While the HMO legislation has suffered from internal incoherence, so has the regulatory legislation. The nation has not yet taken a definitive course.

In discussions of medical care, one often hears about the "fragmentation" and "disorganization" of the health care system. But if the system is disorganized, it has been more than matched by the disorganization of the attempts to change it. And, of course, if the system were really as fragmented as some people seem to think, it would be a good deal easier to change.

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Why non-profits go broke

BRUCE C. VLADECK

THE great voluntary, non-profit institutions that dominate large sectors of public service in the United States are going broke. Especially in health, higher education, and the arts—the three sectors in which non-profit institutions have played the most critical role—bankruptcy is an ever-increasing threat. According to the Director of the United Hospital Fund, no fewer than 17 of New York City's major voluntary hospitals, including several of the world's great teaching/research institutions, face imminent bankruptcy. Private colleges and universities are experiencing the most severe financial crises in history; some smaller colleges have already gone under, and more undoubtedly will follow. The Metropolitan Opera has cut its season, and only large-scale federal subsidies will prevent symphony orchestras, dance companies, and smaller theater organizations from going by the boards. The heads of many of these institutions are not without political influence, and bankruptcy may be averted in many cases by the provision of substantial increases in already sizeable federal largesse. Given the state of the federal budget, however, that is hardly an outcome to be looked on cheerfully.

The most paradoxical and troubling aspect of the problems of the non-profits is that their peril seems to follow so closely upon the

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period of their greatest prosperity and aggrandizement. If the liberal social legislation of the 1960's accomplished nothing else, at least it fed an enormous expansion, both quantitative and qualitative, of the resources and facilities of non-profit organizations. There is hardly a college campus in the nation without a major building completed, or at least begun, in the 1960's. Many entirely new campuses, some with tens of thousands of students, sprang up full blown in that period. The mushrooming of hospitals was less dramatic—the growth curve began shortly after the Second World War—but still considerable, and the explosion of new facilities and equipment within hospital walls was absolutely astounding. The concept of intensive-care units (ICU's), for instance, first came into wide acceptance in the 1960's; five years after that decade concluded, there are literally thousands of ICU's in hospitals of every conceivable size, shape, and location. Similarly, the idea of "community mental health centers" (CMHC's) was only invented in the 1950's; thanks to federal largesse, there are now more than 500 CMHC's scattered across the country. And every city with any aspirations to national prominence boasts of new cultural facilities—if nothing on the gargantuan scale of Lincoln Center, then at least a few new buildings. Yet the organizations which must function within these lavish exteriors are all having trouble meeting their payrolls.

This rapid transition from boom to bust is not fortuitous. It is causal: *The imperatives governing the behavior of non-profit institutions produce, in the absence of sufficiently powerful countervailing pressures, strong tendencies to over-investment. Public policy in support of non-profits has exacerbated those tendencies. The wages of over-investment is financial peril.* Such peril leads, in turn, to higher prices and reductions in service, irritating the more affluent and punishing the poor. And public policies which originated in the dream of extending access to high-quality services for the entire population culminate, in less than a generation, with the emergency subsidization of institutions serving the wealthy and the middle class.

We are all so accustomed to assuming the contrast between private affluence and public squalor—to use Galbraith's terminology—and the appearance of mammoth under-investment in important services is so pervasive, that the notion that too much capital has been invested in sectors like health and higher education may seem exceedingly strange. But every economist or businessman knows that there are critical differences between capital and operating ex-

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penditures, or between fixed and variable costs, and it is in the balance between them that the non-profits have gone wrong.

Self-destructive investment

Services like health or education are, by ineluctable necessity, highly labor-intensive. When one purchases health care or higher education, what one receives is the time, attention, and (presumed) skills of a highly trained professional. Intangible outputs like "health," "education," or "culture" are products only in the sense that they are expected to result from the repeated interactions of producers and consumers; those interactions themselves are the real product of service institutions.

Thus, while traditional economic theory assumes that capital and labor are essentially substitutable for one another, the relationship between them in the voluntary services sector differs radically from that in the private firm. Services are so inherently labor-intensive that the addition of physical capital generally represents not a *substitution* but an *addition* of new forms of activity which require still greater aggregate labor inputs. A portable defibrillator, or renal dialysis unit, or a university language laboratory, or a revolving stage provides clients with a service never before available, but in so doing increases the demand for labor within the institution, rather than reducing it.

Just as corporate planners dream of the days in which their organizations will be completely automated and require no employees—with their bothersome unpredictability, expense, and union membership—so hospital or university administrators no doubt fantasize about automating their janitorial and accounting employees out of work. But hospitals can hardly do without doctors and nurses, or schools without teachers, and those are the expensive employees. When General Motors buys an automated welding machine, it engages in a classic substitution of capital for labor: More cars can be produced by fewer employees. But when a teaching hospital buys a new blood analyzing machine or equips a new cardiac surgery unit, it is expanding the range or improving the quality of the services that can—at best—be provided by the same complement of personnel, and that may, more likely, require the time and effort of still more expensive professionals.

All the elaborate equipment in the world has less value to most patients seeking medical care than a wise physician. Cultural critics appear to agree that the superb new physical plant in which the

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Harkness Ballet performs is still overshadowed by the inadequacies of the company. And at least one plausible image of higher education pictures the ideal physical facility as a log with Horace Mann on one end of it.

The impact of capital investment on non-profit service institutions is thus very different from its impact on profit-making firms. Put most simply, in service industries like health and education, capital by itself is almost entirely non-productive. The "product" there, after all, is an interaction between human beings; and while investment in facilities may marginally improve the frequency or quality of these interactions, it has essentially very little to do with them. The only way to increase output in a hospital without reducing quality is to hire more doctors or nurses, or make them work harder or more efficiently. Capital investment increases output only if it is accompanied by additional labor inputs. It can facilitate or render more sophisticated the labor of professionals, but it cannot substitute for them.

Severe as this analysis may sound, it actually understates the implications of investment for the financial health of non-profit service institutions. On a short-run operating basis, the real crunch lies in the problem of fixed costs. The fixed costs of maintaining and operating physical facilities constitute a largely hidden, but still enormous, drain on non-profits. Because maintenance and overhead appear in budget summaries to be unavoidably fixed costs, they tend to be taken for granted. But those very sizable expenses are quite obviously a direct function of the size and complexity of the physical plant, and should thus, in the long run, be controllable. If overhead is driving the institution into bankruptcy, one would think that the logical solution would be to stop building and investing—even to "disinvest" by closing off classrooms and holding courses at night, by revising last year's sets and costumes, or by shutting down underutilized specialty wards.

The logic of underutilization

Capital investment by non-profit institutions is self-destructive because it increases fixed costs—in a situation where there are precious few variable or controllable costs to begin with—without directly increasing productive capacity at all. Students of hospital economics have long recognized how crucial occupancy rates are to financial stability, precisely because fixed costs are so high a proportion of total expenditures. Increasingly, they have also come to

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recognize the inescapable corollary: Anything that increases capacity without guaranteeing that the new capacity will be fully utilized is going to cause the institution to lose money.

To make matters still worse, most non-profit institutions charge less for the average unit of service they provide than it costs them to produce it, making up the deficit from endowment or some form of subsidization. Even when capital investment—either by itself or, more likely, in conjunction with expansion in the fixed costs of staff—increases productive capacity, it is only increasing the institution's ability to lose money. To the fixed costs of professional labor are added the costs of amortization, interest, designers' fees, and maintenance, without even the expectation that the new income generated will be better able to cover expenses than income has in the past.

No sane profit-making manager would invest in a new plant without adequate assurance that the plant would pay for itself even at substantially less than full capacity. But managers of non-profit institutions continue to throw up new buildings when they know perfectly well that there is no way in which the new facilities can do anything but lose money, even if they are filled to capacity. Of course, those managers will insist that the new facilities will permit them to improve or expand services, but that is true only in the rarest cases. Hospital beds or classroom seats aren't services. Bricks and mortar don't provide services, doctors and professors and violinists do; and while they might be loath to admit it, most of the services they provide can be performed just as well in tents.

The enormous escalation of hospital costs in the last decade has increasingly forced a recognition of the dangers of over-investment in that particular sector of the not-for-profit economy. Elaborate governmental mechanisms have been established to limit and rationalize the construction of new health facilities; and the needless duplication of capacity, especially in highly sophisticated and specialized services such as open-heart surgery, is increasingly pointed to as a major villain in the seemingly endless spiral of hospital charges. All agree that the costs of maintaining underutilized facilities represent almost a sheer waste of money. Yet few carry that logic to its next step, to the recognition that investment in capital facilities is expensive in the long run as well as the short. Instead, in the never-never land of non-profit economics, hospitals blame their deficits on the stinginess of reimbursement formulas and the costs of providing (relatively inexpensive) outpatient services; private colleges lay the blame on the costs of fuel (which goes, of course, to heat essentially unnecessary buildings); and symphony orches-

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tras attribute their perilous conditions to the failure of the United States government to be as generous in subsidization as the French.

The pitfalls of philanthropy

If the non-profits themselves are responsible for their current fix, the question is why they have behaved so self-destructively. Explanations of sheer stupidity or willful perversity, while not entirely implausible, are ultimately unproductive for those concerned with designing policy mechanisms to induce more rational behavior. It is necessary instead to explore other sources of such seemingly irrational behavior.

One explanation hearkens back to the days when "non-profit" was synonymous with "charitable." Much of the funding for non-profit institutions in the fields of health, education, and the arts continues to come from private philanthropy. And private philanthropy tends —at least apparently, as few have ever had the courage to try the alternative—to favor capital construction over operating expenses. There are lots of Widener Libraries and Carnegie Halls, but precious few John Doe monthly payrolls or Richard Roe utility payments. Fund-raising for capital projects always seems easier than fund-raising to increase endowments, which in turn is still substantially easier than the most direct and logical course—the earmarking of charity for operating funds (a strategy which plays a substantial role only in the arts). Cause and effect have become entangled: Because philanthropists only get asked for capital money, they only give capital money; because capital money is all they ever get, non-profits only ask for capital money.

When a donor provides the funds for a new facility, it is assumed by all involved that the recipient institution will pick up the costs of maintenance and operations. But as with Morgan's yacht, it's not the price but the upkeep that dooms institutions to financial insecurity. More insidiously still, many donors, especially the large foundations, have adopted the practice of providing "seed money" on a matching basis, much of which goes for the initial provision of facilities, and then leaving the still-struggling institutions to forage for themselves in the far more perilous world of operating funds.

The "Averch-Johnson effect"

Still, philanthropy represents an ever-decreasing proportion of the total funds of most non-profits. Far more important is the effect of

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cost-based reimbursement or fee schedules. Hospital care is by now an almost entirely regulated industry, in which fees are set by bargaining with a relatively independent, quasi-public third party. Colleges and cultural organizations continue to set their own fees, but they do so in a way designed not to produce a surplus, but to bring total revenue as close as possible to total costs. In all of the non-profit sector, prices (and consequently revenue) are determined not by market considerations, but by the costs of producing service.

Public utilities, of course, have long had rates set for them in just such a way, with the essentially inconsequential exception of allowing for some fixed rate of return on capital. The costs of "producing" a telephone call between Brooklyn and the Bronx, or an airplane trip between Chicago and Los Angeles, are determined, overhead costs are allocated, a fixed percentage return is added on, and the result is the unit price of service.

This kind of "rate-based" regulation has given rise to what students of utility regulation call the "Averch-Johnson effect." When cost determines price, and profit is a percentage of price, then the greater the costs, the greater the absolute profits, even though the *rate* of profits remains fixed. So long as the cost of capital funds is lower than the allowable rate of return, public utilities have a powerful incentive to invest like crazy in capital projects which create fixed costs, which in turn create profits. The more non-productive the capital, the more attractive it is, since non-productive capital adds to the rate base without increasing day-to-day operating expenses, and thus does wonders for cash flow. The "Averch-Johnson effect" explains why the terminals that airlines own themselves (as at Kennedy Airport) tend to be so lavish while the ones that they rent (as at La Guardia) tend to be so spartan; why New York Telephone seems to have a new building on every corner; and why, in many smaller cities, the handful of extravagant skyscrapers almost invariably includes the local electric utility and the local phone company.

Like public utilities, non-profit service institutions have a high ratio of fixed to variable costs, and although the formal patterns are different, their prices are also set in much the same way. The prices which voluntary hospitals charge for their services are based on "reasonable costs," which include the costs of capital investment and the interest payments associated with it. Increased interest, amortization, or overhead costs increase reimbursements and therefore budgets. Even in the absence of a profit criterion, it is an ex-

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ceedingly rare bureaucratic executive who does not desire an increase in the size of his organization's revenues.[1] Universities and cultural organizations set prices in an ostensibly different manner: Like the hospitals, they *begin* by determining their costs, but then they subtract anticipated revenues from endowment, philanthropy, and government, and divide the remainder by the expected volume of clientele. The 10 bucks spent for an opera ticket, or the three thousand dollars for a year's college tuition, has no direct relation at all to the marginal cost to the institution of providing the service. Instead, it represents the end-product of a calculation in which total revenues are set equal to total costs—and in which costs are determined first.[2]

If an influential member of the board of trustees desires to memorialize himself (and diminish his estate-tax liability) by putting up half the cost of a new and essentially useless auditorium, the institution thus has precious little incentive to say no. Indeed, administrators of non-profits have little incentive to say no to anyone desiring increased capital expenditures, so long as they remain relatively confident that someone can be found to pay for them. The way in which non-profits set their prices, and the low price elasticity of consumer demand, permit administrators to hide from themselves the true implications of such spending. Investment projects come before the administrator as sources of "free" money—because they will be paid for either by public or private philanthropy or by consumers and their third-party representatives—that

[1] Even when reimbursement formulas do not allow for any fixed-percentage add-on to costs—either directly or through such transparent devices as the eight per cent "nursing allowance" permitted hospitals under Medicare reimbursement—non-profits can still "profit" from cost-based reimbursement when they are allowed to include depreciation as a cost and are not required to fund it. The depreciation then simply becomes an additional source of cash for administrators to use at their discretion—and there is nothing administrators like better. Here, it should be stressed, it is important that the costs are *capital* investment costs, since only physical plants and facilities are depreciable. In other words, the agreement of third-party reimbursers to allow depreciation as a part of the cost base without requiring it to be funded creates a particularly strong form of the "Averch-Johnson effect" encouraging over-investment.

[2] All pretenses aside, the financing of operating costs for voluntary hospitals increasingly is moving away from the "rate-base" model of utility regulation to the related model of price-setting in colleges and cultural institutions. At the end of the fiscal year, the hospitals go to Blue Cross with the claim that existing reimbursement schedules are producing a deficit of so many millions of dollars. Blue Cross counters with its own figures, and a compromise is eventually reached on the new rates, which by then bear only the most tenuous relationship to actual costs—since no one has any idea of what they really are—and are instead designed to make up the difference between total expenses and other revenues by assuming a certain level of utilization and dividing the expected revenue shortfall by that amount.

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do not impinge on operating margins. Whatever incentives there might be for expansion—whether the desire to improve services, reduce intra-organizational conflict, or build empires—are not counterbalanced by economic disincentives. Indeed, economic considerations reinforce pressures to over-invest.

Non-profit "superstars"

Most important among the non-economic incentives for expansion is the desire for institutional prestige. The production of services like "medical care" or "higher education" is almost entirely dependent, it should be remembered, on the activity of a relatively small number of highly-skilled professionals. Rightfully or not, it is widely believed that certain highly desirable attributes are distributed unevenly among such professionals. The institution which employs a disproportionate number of those thought to be especially talented or gifted thus gains, in turn, enormously enhanced prestige, status, and influence. Medicine, education, and the performing arts are all characterized by the domination of "superstars," and the key to institutional success in any of those fields is the employment of several of them. Just like the professional basketball franchise which can guarantee its future success by signing a seven-foot center from UCLA, a university or medical center which adds a Nobel laureate to its payroll identifies itself as an institution that cannot be overlooked.

Unlike professional basketball players, however, famous medical researchers or professors of physics occupy a subculture governed by norms (and influential actors like boards of trustees and legislatures) which forbid the payment of six-figure salaries in all but the rarest cases. Indirect or *sub rosa* forms of compensation are also frowned upon—imagine the uproar if Harvard began buying Eldorados for holders of its endowed chairs. So non-profit "superstars" are lured from one institution to another by the presence of others of their ilk—an extremely circular process—and by the promise of physical facilities and surroundings appropriate to such great men. If you want to build a great physics department, you have to invest millions in linear accelerators, and even if you can get someone else to pay for construction, you are likely to be stuck with the costs of sweeping up the place at night. Hospitals seeking national reputations provide specialized equipment for practitioners of the most arcane sub-specialties, and then have to fly patients in from around the country to keep those facilities busy, while citizens

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of the surrounding community with more mundane ailments go underserved. A museum anxious for a distinguished collector to donate his holdings is likely to offer to build a new wing to house them —even if the debt service on the new structure forces the institution to reduce operating costs by cutting the number of hours it is open so that hardly anyone has a chance to see the new collection.

Unfortunately, in contrast to the "superstars" of professional sports, the "superstars" of medicine and education and the arts provide no guarantee that their presence will assure the institution's solvency. Indeed, their impact is likely to be just the opposite. Given the general reluctance of "superstars" to devote any considerable proportion of their time to the activities which constitute the bread and butter of the organization—such as teaching—their activities are more likely to result in increases in expenses than in income.

The push for prestige

The energy devoted to the recruitment of "superstars" is generally justified by the argument that their presence attracts sources of funds like foundations and the research agencies of the federal government. That argument is fine so far as it goes, but all too often the public or private largesse attracted by the "superstars" goes primarily towards further over-investment in physical plants and expensive, highly specialized equipment, or to the hiring of additional personnel, most of whose time is devoted to the "superstars'" ends, and whose presence creates the need for still more personnel clerks, parking spaces, and janitorial services.[3]

In a sense, the problem of "superstars" is only a special case of the more general rule of institutional imperatives in the non-profit sector: the subordination of service goals to institutional prestige. Administrators, after all, have to maximize something in order to justify their salaries to themselves and the boards which hire them. They can't very well maximize profits, and while they like to think of themselves as attempting to maximize (under exceedingly severe constraints) the delivery of high-quality services, they can't very well do that either, since no one has a very good idea of what high quality services would look like, or how one would go about providing them.

So administrators of non-profit institutions gauge their performance by essentially irrelevant measures, such as the expansion of the physical plant or the acquisition of new, technologically sophis-

[3] Indeed, the suppliers of research money look with increasingly jaundiced eyes on any diversion of grant funds to general institutional upkeep.

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ticated equipment. Everyone knows that bigger is not necessarily better, but since it is difficult to decide what is better in non-profit areas, becoming bigger attains a central motivational role.

Pressures for physical growth become more potent still in those communities in which non-profits compete not against a generalized standard of putative prestige, but directly against one another. When a group of physicians dissatisfied with the pecking order in a community hospital break off to form their own, they are hardly going to be satisfied until they have at least duplicated all the esoteric equipment in the older facility. When a millionaire becomes disillusioned with the way in which the old museum displays his collection, he can be expected to attempt to erect an edifice putting that ungrateful institution to shame. And the alumni of one school are hardly going to be satisfied unless the new student center is at least twice as opulent as that of the arch rival.

With the kind of reflexive reaction of which only economists are capable, it has often been suggested that the solution to the managerial shortcomings of non-profits lies in increasing competition among them. The looking-glass world of non-profit economics, however, transforms what is simple economics in the private sector into a prescription for disaster. Competition among non-profits induces not greater efficiency but greater inefficiency. Instead of forcing organizations to minimize costs, it induces them to maximize capital costs—playing havoc with cash flow.

Pork-barrel politics

The significant public-policy questions posed by the impending bankruptcy of the non-profits and the cause of that bankruptcy in over-investment, however, lie not in the institutional imperatives for over-investment, but in the ways in which those tendencies have been reinforced, expanded, and even accelerated by government action. The non-profits by themselves are hardly responsible for getting themselves into the mess they currently occupy; indeed, most of them are so ineptly managed that they can hardly get themselves into trouble, let alone out. The rampant over-investment in the non-profit sector, and its consequences for the financial and institutional health of non-profit institutions, are largely the government's doing.

Most of the new libraries and dormitories and hospital beds and cultural palaces, whose upkeep is driving the non-profits to the wall, are products of direct or indirect federal largesse. Twenty years before the federal government dipped its toes into the waters of health

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insurance with Medicare, it began providing funds for hospital and health facilities construction. The Hill-Burton Act of 1946 was originally designed, at least in the eyes of some of its sponsors, to provide funds for the construction of hospitals in rural communities where there were no facilities available at all. Like many pork-barrel programs, however, its benefits have been distributed to every city and town regardless of whether or not there was a need for additional construction. If a city already had a hospital, it could always build another one; if it already had as many hospitals as it could possibly use, it could always expand the ones it had. Hill-Burton has provided almost *$4 billion* for hospital construction, and has, by the most recent estimates, generated a surplus approaching 60,000 hospital beds—the maintenance of which costs more than $1 billion a year.[4]

Hill-Burton was only the forerunner, however, of the spate of Great Society programs that generated the greatest wave of public construction for private use since the Second World War. For each category of government action undertaken or expanded by the Great Society—aid to the handicapped, to health, to education—there was at least one program of grants or loans for facilities, many of which would be owned by non-profit institutions. Private universities, as well as public ones, got new classrooms, dormitories, and libraries; not only hospitals but free-standing clinics, community mental health facilities, and more specialized kinds of health services built facilities with federal funds; and while categorical assistance to the arts tended to take the form of operating subsidies, literally dozens of concert halls, theaters, and museums were built under the aegis of federally-supported urban renewal programs.

Governmental gift horses

As the Great Society began to dry up, the operating subsidies that had, in many instances, originally accompanied the construction funds then withered away—while the federally-built facilities didn't. The severity with which the energy shortage has hit private colleges

[4] The federally-funded over-investment in hospital facilities has been so severe that it has generated a sizable, though still largely ineffective, counter-trend. The Comprehensive Health Planning Act of 1966 was partially motivated by a desire to find a mechanism to control over-investment in health facilities, especially hospitals. Its failure to do so was a major force behind the sections of the 1972 Social Security Amendments which forbid Medicare or Medicaid reimbursement for facilities constructed without appropriate "certificates of need" from designated state agencies. Only a few states, however, have had the courage to say no to influential hospital trustees and adminis-

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is only one example of the difficulties caused for non-profits by the costs of operating and maintaining their federal gift horses. In the longer run, federally-built facilities will be either the millstones that drag the non-profit institutions under financially, or one of the principal sources of increasing demands for federal operating subsidies, and major consumers of those subsidies.

Behind the federal emphasis on the construction of facilities as a part of the Great Society were a number of political considerations. Professionals, jealous of their independence and the advantages of cartelization in a "free market," tended to resist direct institutional support, which might give the government some actual policy leverage. Further, spending money for what is thought to be the promotion of social services has a double payoff: Not only can one look like a supplier of largesse to those in need of valuable services like health care and higher education, but at the same time one can curry favor and patronage from contractors, materials suppliers, and the politically-active building trades unions.

The most powerful incentive for over-investment by non-profits is not federal at all, though it is governmental: the exemption of the physical plant from property taxes. Of course, the income of non-profits is also exempt from taxation, but most non-profits don't have enough income left over after paying expenses for that to be worth worrying about. Indeed, one might well argue that most non-profits are sufficiently sensitive to the implications of their income tax exemptions that they labor mightily to minimize their surpluses. Too large a "reserve" would be embarrassing. The ability to sink potentially discomfiting reserves into bricks and mortar thus provides an attractive way out. Administrators can continue to maximize gross revenue—and thus gross administrative power and prestige—while disposing of embarrassing revenue excesses in ways that redound to the greater glory of the institution.

In consequence, those cities most blessed by the presence of large numbers of prestigious service institutions (Boston being perhaps the extreme case) have experienced a progressive withdrawal of the most desirable property from the tax rolls. Because of the diminished tax base, the cities are increasingly harder put to provide necessary services. Yet the non-profits, which might theoretically

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trators; and while the impact of the 1972 Amendments has been reinforced by a gradual drying-up of Hill-Burton funds, hospitals have begun to discuss private capital markets, especially in tax-free municipal bonds, as an alternative source of capital. In other words, while recent federal legislation has made it much more difficult for health facilities to blindly proceed with expansion, determined administrators can generally find the money somewhere.

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be able to take up some of the slack, are themselves being driven into bankruptcy trying to maintain those very properties, and are thus reducing services precisely at a time when increases are most necessary. With the exception of affluent suburbanites who enjoy the services of non-profits at essentially subsidized prices, everyone loses, especially the poor and working-class city-dwellers whose taxes finance inadequate health care and institutions of higher education that their children cannot afford to attend.

Curbing over-investment

While there is little government can do directly to keep the non-profits from destroying themselves, it can at least modify policies that encourage self-destruction. Existing income-taxation policies, for example, make no distinction between tax-exempt donations for capital construction and those for other purposes. Since, all other things being equal, many potential donors would rather give for construction than operating expenses, the Internal Revenue Code reinforces their preference. It would be easy enough to discourage them, by applying differential rates of taxation on contributions intended for facilities as opposed to donations for operating expenses or endowment.

Instead of maintaining the exemption from property taxes for all non-profit facilities, localities might brake over-investment by taxing improvements on the basis of fully-depreciated value, with the provision that the value of any improvement more than 10 or 15 years old be assumed to have depreciated to zero. Non-profits would be adversely affected by this policy only to the extent that they desired to throw their money away on new facilities or the reconstruction of old ones. The tax costs of new property would reflect more "truly" the economic impact of the investment, and would induce more rational economizing on the part of non-profit managers. Should hospitals or universities experience a legitimate need for facilities expansion, the taxes will not be an insuperable burden. Besides, facilities can always be rented, shifting the amortization problem to someone else and creating a more effective hedge against the kinds of fluctuations in demand to which non-profits are particularly susceptible, and which tend to aggravate the tendencies to over-investment.

Since the federal government wields considerable power over the ways in which non-profit corporations keep their books—the Department of Health, Education, and Welfare, for example, has

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long maintained standards for certain accounting practices for hospitals and school districts receiving federal funds, and is now under Congressional mandate to develop a uniform nationwide code of hospital cost-accounting—it could require accounting practices that expose the costs of over-investment. For example, non-profits, just like municipal governments, often keep separate sets of accounts for facility construction. So long as those accounts remain in balance, managers are permitted the illusion that all is well on the capital side and that their financial problems are caused by some mysterious drain on operating funds. More likely, that mysterious drain is produced by overhead charges implied in past capital expenditures, but appearing in the operating budget. Congress now requires the Department of Defense to keep track of the full "life-cycle" costs of new weapons systems, including not only the procurement itself but also associated equipment and supply expenditures, maintenance, and personnel requirements. Congress could mandate similar rules for non-profit recipients of federal largesse. Thus, a university desiring a new chemistry lab could be required to make provision not only for the space and equipment, but for the newly hired technicians and janitors who will work there, the overhead costs of heat and electricity, and the demand for extra parking spaces the new staff is sure to generate—and to demonstrate its ability to find someone to pay those costs.

Ironically, one of the reasons that universities and hospitals are so strapped for cash is that governments, in their purchases of research efforts or direct services, have become so hard-nosed about overhead costs. Universities are increasingly less able to palm off the general costs of running their enterprises on specifically-targeted grants or subsidies. At the same time, however, government continues to support new construction without adequate planning for operations, creating an inescapable vise for the institutions it is supposed to be supporting. Better accounting practices might make the contradiction apparent to funding sources, inducing them to rethink their policies.

From boom to bust

At the very least, such improvements in accounting would let the managers of non-profits see more clearly what it is they are doing when they invest money in facilities. Some thought might also be given to managing more sensibly some of the supply of that money. The boom and bust cycle of government spending in the civilian

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sector reinforces the inherent tendencies of non-profits in a particularly insidious way. In caricature, the boom takes the form of construction money; the bust cuts into operating funds.

Part of the problem here is political. New facilities are far more visible—and more easily spread among Congressional districts—than operating money. It is easy for a Congressman to take political credit for a new hospital wing or dormitory, far more difficult to reap advantage from operating subsidies. But another part of the problem arises from a misguided conception of the government as a "catalyst" or supplier of initial impetus. The shadow of free-market ideology suggests that once the infant is breathing, it should be left to fend for itself. More often, it falls on its face.

If the government were to pay directly for services it thought intrinsically worthwhile—through health insurance or scholarships or symphony stamps—those non-profits which "succeeded" in the "marketplace" probably would be able to generate enough revenue internally to pay for whatever facilities they could economically support. Politically unpalatable though such an approach might be, it would create healthier institutions than the current cycle of seed money followed by starvation. It should be added that foundations have been guilty of much the same sins as the Great Society in this, and could well be admonished to follow the same alternatives.

It has been long established that artists—and, by extension, doctors and teachers and Indian chiefs—don't *need* garrets in order to perform at peak professional levels. But the converse, no less true, is often forgotten. Provide them with palaces, and they will be so busy trying to scare up the rent that they won't have time or energy to give superior services to clients.

That greatest of all organization theorists, C. Northcote Parkinson, wrote many years ago that one could identify with precision the point at which an important institution began to slide downhill: when it opened its beautiful new facility. As examples he suggested the British War Office, The League of Nations, and the United Nations. Citizens of contemporary America could provide many other examples. What Parkinson failed to recognize, however, was that the relationship he so correctly perceived was not merely fortuitous, but directly causal. Marble palaces may do wonders for institutional self-esteem and sense of well-being, but they don't provide services, and they certainly don't heat, light, or clean themselves. So long as they continue to consume large proportions of precious resources, the services they are supposed to help provide will continue to be undernourished.

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Social Science and the Courts: The Detroit Schools Case

ELEANOR P. WOLF

THE role of the social sciences in judicial decision-making has received considerable attention from the field of law, and in recent years much of this attention has focused on issues related to school segregation.[1] Social scientists have not paid nearly so much attention—few, for example, have chosen to make a detailed study of a single case. Yet many of the Northern school cases—involving, as they do, issues of greater complexity and ambiguity than the cases concerning the openly dual systems of the pre-1954 South—have used substantial amounts of social-science materials. In addition, the significance of a single case in law is somewhat different than is generally true in the social sciences because of the controlling effects of precedent.

In April of 1971, the National Association for the Advancement of Colored People (NAACP) brought a lawsuit before a federal district court, charging *de jure* segregation within the Detroit school system. This case led to a decision upholding the charges of the NAACP, and subsequently to an order for inter-district busing. The decision was upheld by the 6th Circuit Court of Appeals, but the inter-district busing remedy was reversed by the Supreme Court in a 5-4 decision in 1974. I undertook a study of all the testimony presented in the course of the landmark Detroit case[2] in order to discover what kinds of social-science materials were introduced, and to evaluate their quality and comprehensiveness. I wanted to learn whether there were crucial omissions of evidence that otherwise might have supported, contradicted, or modified the testimony that was introduced. I also wanted to discover how the court dealt with the considerable and sometimes conflicting array of demographic data presented and to evaluate the extent to which the judicial de-

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cisions, at various levels, accurately reflected the weight of the social-science evidence that had been offered. Finally, if the study revealed (as I anticipated, from preliminary investigation, that it might) certain problems and inadequacies in the use of social-science materials in the courtroom, I hoped to indicate some possible avenues for improvement.

The basic material for analysis was the verbatim transcript of the 41-day trial, held in 1971, as well as many of the exhibits offered in evidence, plus the transcript of the court hearings conducted the following year on alternative plans for desegregation. The chief areas of social-science concern, broadly classified, were 1) the extent, nature, and causes of racial separation in urban neighborhoods; 2) the economic, social, and psychological factors—both in and out of school—believed to be associated with various aspects of learning; and 3) the allegations and refutations of segregative practices within the school system. I had not foreseen the extent to which social-science materials would be involved in this last category, but there proved to be many references to demographic, sociological, and psychological factors in the course of disputed testimony concerning the reasons for and consequences of various school system policies and practices. A completely unexpected category was the rather considerable amount of testimony (and controversy) about methodology, some of it in response to challenges to the validity of evidence that had been introduced.

THE decision of the Federal District Court on September 27, 1971, declaring Detroit schools to be segregated *de jure* was marked by the unusual prominence given to consideration of demographic trends and to an extended discussion of the nature and causes of racially segregated housing. That portion of the decision concerned with those matters opened with these words: "In considering the present racial complexion of the City of Detroit and its public school system we must first look to the past and view in perspective what has happened in the last half century."[3] This was followed by almost seven pages (about one third of the text) on housing, population movements, demographic characteristics, and their effects on the schools. These findings were a largely accurate reflection of the testimony that had been presented on a wide range of specific topics in this general subject area: the measurement of segregation in housing; comparisons between the housing patterns of blacks and white ethnics; practices and policies, past and present, of the real estate industry; economic factors in residential choices of blacks; the impact upon housing patterns of government policy in urban renewal, public housing, FHA, and other federal programs; and the earlier judicial enforcement of restrictive covenants. Both the trial and the remedy hearings were marked by frequent references to "white flight" and its alleged causes; and school policy decisions, past and projected, were frequently rationalized by references to "white flight" and to the operation of a "tipping point" in schools and in housing.

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Judge Roth's decision drew the following conclusions about the causes of residential segregation:

> While the racially unrestricted choice of black persons and economic factors may have played some part in the development of this pattern of residential segregation it is, in the main, the result of past and present practices and customs of racial discrimination both public and private, which have and do restrict the housing opportunities of black people. On the record, there can be no other finding.[4]

The record, however, was entirely the presentation of the plaintiffs. Because the defendants took the legal position that testimony about housing was irrelevant to the charge that Detroit's schools were segregated *de jure*, they offered no evidence on this subject. Regardless of the legal aspects, the fact that all of the housing witnesses were selected by one side tended to restrict the range of issues and narrow the perspective offered in this testimony. As a basis for understanding the relative impact of a variety of factors involved in fashioning social policy (which was what was happening here) the court was not well served by this method of presentation. This became even more apparent during the discussions of remedies, when plans for desegregation were developed, to a large extent, on the basis of inadequately verified hypotheses concerning residential behavior.

Since legal advantage, rather than sociological relevance, governed the choice of materials to be presented, there was no testimony that reflected the studies of scholars who attribute greater importance to the economic ability of blacks[5] or who stress the significance of the social class distribution of blacks[6] in accounting for the residential preferences of *whites*.[7] There was no testimony that emphasized the similarities, rather than the differences, between the residential behavior of blacks and that of other ethnic groups; indeed, no expert who testified appeared to define black Americans in these terms.[8] There was no reference to research revealing the continuing strength of social relationships among ethnic groups (including blacks) despite cultural assimilation.[9] The testimony on the causes of racial transition in urban neighborhoods was very sparse, consisting of references to solicitation by real-estate agents and the racial prejudice of whites.[10] No testimony challenged the assertion that there is a "corresponding effect" between the racial composition of a school and that of a neighborhood—the phrase suggests a force of comparable magnitude in either direction.[11]

The effect of omissions of content was compounded by the style of presentation. The limitations of the adversary mode in the presentation of social-science evidence were accentuated by the fact that most of the expert witnesses on housing were from social action agencies rather than the academic disciplines. Karl Taeuber, the notable demographer, who offered the best testimony during the trial, was virtually the only scholar. The background and customary responsibilities of civil rights professionals involve the use of knowledge to persuade and convert. Speakers exaggerate cer-

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tainty, omit contrary evidence, and fail to acknowledge gaps in the data or in causal linkages. They do not reveal, or perhaps are not aware of, methodological weaknesses that require many conclusions to be held quite tentatively.

From the record of housing segregation established in the trial the Federal District Court proceeded to the declaration that there was an "affirmative obligation of the defendant Board . . . to adopt and implement pupil assignment practices and policies that compensate for and avoid incorporation into the school system the effects of residential racial segregation."[12] In view of this emphasis, it is surprising to discover that the 6th Circuit Court of Appeals, while upholding the finding that Detroit schools were segregated *de jure*, specifically rejected this contention, which had figured so largely in the District Court's chain of reasoning, and removed all of the references to housing that had been so prominent in Judge Roth's decision:

> In affirming the District Judge's findings of constitutional violation by the Detroit Board of Education and by the State defendants . . . we have not relied at all upon testimony pertaining to segregated housing except as school construction programs helped cause or maintain such segregation.[13]

Nor did the Appeals Court refer to any "affirmative duty" of a school system, in a residentially segregated city, to abandon a geographical policy of pupil assignment. (If such a duty were upheld, virtually every city with a significant percentage of blacks would be obliged to use a criterion other than distance from school as the basis for assignment, and there would be no need for litigation to prove specific acts of discrimination and segregation by school officials.) Perhaps the Appeals Court recognized that, given the continued legality of geographical assignment, the emphasis Judge Roth had placed on residential segregation and demographic changes greatly weakened the charges against the school system. If a city is "divided along racial lines," if segregation is "substantial, pervasive, and of long standing," with blacks living in "separate and distinct areas within the city,"[14] and if demographic processes (e.g., migration and differing age distribution of whites and blacks) create a "complete change in student population from white to black,"[15] further adumbration of causes for school segregation appears logically redundant. (Justice White does not agree. In his dissent he said: "Had the Detroit school system not followed an official policy of segregation throughout the 1950's and 1960's, Negroes and Whites would have been going to school together."[16]) But the housing evidence, although ignored by the 6th Circuit Court of Appeals, played a very important role in the Detroit case. In addition to the expert witnesses on housing, there was testimony by several black real-estate brokers. Their plain-spoken narrative accounts of rebuff, subterfuge, and humiliation in their attempts to secure listings in white areas are very moving. Comments (in the

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transcript) from the defendants' counsel and the reports of observers at the trial suggests that this material also made a deep impression upon the listeners, and especially upon Judge Roth.

The message of the housing testimony was that racial segregation arose from discrimination based on prejudice, aided and abetted by government, and that it was severe, widespread, unresponsive to economic improvement, worsened by the passage of time, and impervious to the assimilative processes that had dispersed other groups. So said the housing experts. If traditional pupil-assignment practices continued, there was no hope for the emergence of the mixed schools which, in the virtually unanimous opinion of the education experts who were to follow, were indispensable for educational achievement.

A considerable amount of expert testimony on education was offered during both the trial in 1971, and the hearing on desegregation plans conducted by Judge Roth in 1972. A wide range of issues was covered, some at great length, some briefly: the relationship between a child's background and academic achievement; the definition and measurement of socio-economic status; the class-linked differences in attitudes, values, and overt behavior; and various problems in the definition and measurement of intelligence. There was a great deal of testimony on the effects of varying degrees of race and social-class mixture upon academic achievement, and upon other outcomes such as self-concept, motivation, aspirations, racial attitudes, and race relations. There was testimony on the effects of "tracking," ability-grouping, and the validity of tests used for such placement. There were presentations on the allocation of a variety of educational resources, with much emphasis on teachers' training, experience, skills, attitudes, and expectations.

During the remedy hearings, as the comparative merits of the several proposals for desegregation were considered, there was a great deal of additional testimony on the presumed effects of certain proportions of race and social-class mixture. These hearings also included much testimony on the expected effects of all of these factors on residential behavior. New social-science issues also emerged during these hearings: how large a proportion black would be needed to protect what was termed "identity," or sometimes "self-identity"; the effects on children of more frequent changes in school assignment; and the effects of distance upon parental involvement in school affairs and on "community control" (a form of which had recently been introduced in Detroit).

Taken as a whole, the expert testimony about education was characterized by a number of serious omissions. There were no references to the differences in educational achievement between ethnic groups at similar income levels, although such differences are widely known and reasonably well documented.[17] Although erroneous testimony by the plaintiffs' chief education witness (who asserted that, for the most part, entry-level differences between pupils are minimal) was corrected by the defendants' educational

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experts almost two months later,[18] it was never revealed that the capacity of schools to eradicate these differences has not thus far been demonstrated. No social-science expert challenged, modified, or even questioned assertions about educational and psychological harm from grouping by scholastic proficiency or more general aptitudes.[19] No expert questioned the many exaggerated assertions made by both sides concerning research findings on the effects of teacher attitudes (the so-called "expectancy hypothesis") on student achievement, despite a considerable array of critical material on this work.[20] No social-science testimony systematically evaluated the incompatibility seen by many analysts between community control of schools and large-scale programs of pupil dispersion for the purpose of integration.[21]

Perhaps most crucial of all, there was no serious challenge to the exaggerated claims, made by expert witnesses on both sides, of the power of racial and social-class mixture of classmates to improve the educational performance of low-achieving students. Yet there was, even by the time of the trial, a substantial literature on this matter, including material by the often-cited James Coleman, written in apparent response to unwarranted assertions about the power of classroom heterogeneity.[22] At many points the (strong) effects of the *individual child's* socio-economic background on academic performance was confused with the weak (and doubtful) effects of his *classmates'* socio-economic status.[23] The general import of the testimony on education was such as to persuade a reasonable man without research training or academic background that the proper kind of race-class mix in the classroom would heighten aspirations, improve motivation, raise self-esteem, and improve the academic performance of low-achieving black children. Simultaneously, contact with these children would reduce the prejudices and correct the stereotypes of whites, thus improving race relations. But there is little support in the professional literature for this dubious set of propositions.

There were virtually no references in the rulings of the Federal District Court or the 6th Circuit Court of Appeals to educational harm stemming from predominantly one-race schools, or to the educational benefits from mixture, despite the very substantial amount of testimony on these subjects. Research findings on these effects appear increasingly inconclusive in recent years. In the light of much criticism and uncertainty, there is a new reluctance to rely upon such data on the part of some who were previously enthusiastic about utilizing such data.[24] Paul Dimond (NAACP co-counsel) expressed a current appraisal in a recent article: "I do not believe the evidence on educational advantage proves much of anything."[25] This is a striking contrast to many past claims, and one must note that no such admission was made during the trial.

Why, then, in the light of this increased skepticism, was material on educational effects offered by the plaintiffs? Two reasons come to mind: 1) Since the legal basis for findings on Northern-style school segregation is still not completely established, it is prudent

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to be as inclusive as possible; and 2) such material has an important role in persuading a judge that equal educational opportunity requires racially-mixed schools. In the Detroit case this conviction was apparently shared by both sides, who often seemed to be vying with each other in expressing their ideological commitment to this goal.[26] The board of education expert witnesses would yield to no one in their devotion to integration; they differed mainly in contending that by the time the system had acquired a strongly pro-integration leadership, the demography of the Detroit public schools (already a majority of blacks before Norman Drachler became superintendent in 1966) made overall success impossible.[27]

The expert testimony, then, on both housing and education, was marked by a high degree of consensus. Although the defendants presented no witnesses of their own on residential patterns, at some points they indicated their unwillingness to be associated with any attempt to rebut or minimize the evidence about discrimination in housing. We have already noted that there appeared to be genuine agreement between the adversaries on the benefits of integration, the harm of racial isolation in schools, and the moral and ideological imperatives of the goal of integration.

If the contrast in statements made by Judge Roth before and after the trial is an indication of his beliefs, this high degree of consensus by experts was not without effect. The judge was a conservative among Democrats and had not been associated with civil-rights efforts.[28] His pre-trial ruling in favor of a voluntary integration plan (backed by more conservative members of the Detroit school board) and against the rather limited "April 7 Plan"—the rejection of which resulted in the Detroit case[29]—indicates his original orientation. In that ruling he praised the "magnet plan" because "it is voluntary," whereas "the April Plan's principal aim is to improve integration by the numbers . . . it does not offer incentive . . . or provide motivation. . . . Instead of a change of diet it offers forced feeding." He concluded: "It is our belief that in this way [the "magnet plan"] the students, in their quest for identity and in their inherited drive for realizing their potential, will bring about such integration as no coercive method could possibly achieve."[30]

From this disinclination to select a mildly "coercive" plan involving a limited number of high school students, the judge moved to the following declaration of aim shortly after the conclusion of the trial: ". . . the task we are called upon to perform is a social one which society has been unable to accomplish. In reality, our courts are called upon in these school cases to attain a goal through the educational system by using the law as a lever."[31]

The instrument eventually chosen to attain this goal was a metropolitan plan of unprecedented dimensions, involving the reassignment and dispersion over a considerable area of a large proportion of the 780,000 students, of all ages, from 53 school systems. The legal basis cited for this remedy, however, was not the social-science testimony, but the evidence of constitutional violations within the school system.

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THE Appeals Court had rejected housing segregation as a basis for concurrence with the District Court's ruling of segregation *de jure* in Detroit's schools, and neither court had made more than passing reference to the educational harm from segregation or the expected benefits of integration, despite the substantial testimony on these matters. This left the ruling on Detroit based almost entirely on findings of racial discrimination, largely by the school board acting under State authority. Indeed, the Supreme Court's 5-4 reversal of the inter-district remedy was based on the legal doctrine that, in the absence of sufficient evidence on such violations by the suburban school districts, the scope and nature of the remedy exceeded the scope and nature of the violations.

It is hard to escape the conclusion that Judge Roth's use of school violations was a reluctant concession to the requirements of legal precedent. "It is unfortunate," he declared "that we cannot deal with public school segregation on a no-fault basis, for if racial segregation . . . is an evil . . . it should make no difference whether we classify it *de jure* or *de facto*. . . . Our objective . . . should be to remedy a condition which we believe needs correction." [32] In an apparent effort to maintain consistency and continuity with the Southern school cases, the courts have ruled thus far that desegregation can be imposed only to remedy a condition of segregation *de jure*—i.e., some features of a dual system, however covert or subtle, must have been found. This evidence of constitutional violations then becomes, to use the language of Owen Fiss, the "trigger" which can fire the "cannon" [33] of mandatory desegregation: dispersed school assignment to make schools as racially "un-identifiable" as is practical and feasible. Fiss, in discussing the *Swann* case, characterized this "theory for attributing responsibility" as "contrived," and defensible only if "the primary concern of the courts is the segregated patterns themselves, rather than the causal relation of past discrimination to them." [34]

Fiss had said only that the theory "seems contrived." What about the evidence? My original intention in studying the school-violations testimony was to learn how a judge went about the task of evaluating the validity and assessing the significance of great masses of factual data concerning unfamiliar subjects. I approached the testimony on recent school violations with skepticism, on three counts: First, from a sociologist's perspective, if schools were already completely segregated as a consequence of residential patterns, the "principle of parsimony" seemed to argue against further "explanations" for this condition. Second, my own research in changing neighborhoods suggested that the school system had been trying to maintain integrated schools, albeit with inadequate and ineffective tools.[35] Third, it did not seem likely that a pro-integration superintendent and school board president (both winners of NAACP awards) and a deputy superintendent (who had spent most of his career as local executive of the NAACP) whose responsibility it was to study and approve changes in boundaries, feeder patterns, and transportation would countenance racial discrimination. If the

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courts' assessments concerning recent school violations had been accurate, it was important to learn if the testimony revealed the ways in which their supervision had been evaded, their orders disobeyed, and their aims frustrated.

THE school-violations testimony is voluminous—and formidable. In addition to hundreds of hours of oral presentations[36] there are maps, charts, racial counts (since 1961), data on present and anticipated population movements and on school building and room capacity, considerations of local geography and traffic arteries, problems of changing parochial school enrollments—plus the whole problem of school organization, at times clearly confusing to the judge. Some of this testimony covered a period of almost 20 years.

One category of school violations concerned site-selection. The facts here were not in doubt: The newly built Joffe Elementary School, for example, was small and the only children who lived nearby (and not so nearby) were black; it was thus predictable that it would be a "one-race school." Does this constitute segregation *de jure*? The District Court so ruled; the Appeals Court concurred; and the Supreme Court let the decision stand.[37] To a considerable extent, as a reading of these decisions will show, the charges of constitutional violations involved site-selection for construction of schools. But the line between facts and their interpretation is unclear: Could a school have been erected in a different spot to create a mixed enrollment? Facts about racial composition and residential trends in an area are needed, as well as the weighing of certain values (the choice between a small neighborhood primary school with a homogeneous enrollment and a larger and more distant one which is heterogeneous) and legal interpretations that are not reducible to facts. If, for example, population facts indicate that the race mixture of a neighborhood will be quite temporary (how temporary?), is such a site choice "segregation"?

A second category of school violations concerned discriminatory pupil-transportation practices. The charge that black students from an overcrowded school were bused past a predominantly white school (which had space for them) to a predominantly black school is—if the facts are correct—not subject to the same problems of interpretations involved in charges concerning site-selection. Did the adversary method of the courtroom produce accurate information about these events? Because of the difficulty of investigating episodes of this type which had occurred in the past—the defendants conceded that some episodes did take place—my attempts to verify these assertions were confined to the most recent instances mentioned in the decision rendered by the 6th Circuit. I discovered that incomplete and inaccurate factual material was accepted as evidence of school violations and incorporated into the decisions.

A third category of school offenses had to do with boundary changes, feeder patterns, and the exercise of parental choice on some blocks between boundaries (the so-called "optional zones"[38]). This subject involves both a mass of factual data and possible alter-

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native explanations offered for these events. Each instance requires a separate investigation to check fact-accuracy, greatly complicated by the fact that a single change in a feeder pattern often has a "domino" or ripple effect. Some of these violations of 15 or more years ago, as well as some more recent, were admitted by the defendants to have indeed taken place under earlier administrations.

I had not anticipated the extent to which (ill-defined) concepts and assumptions from the social sciences would be involved in this testimony. For example, the plaintiffs' expert witness often declared that a certain change in student assignments "increased" or "decreased" the "community's perception of segregation," and thus contributed to segregation generally, presumably because of an eventual impact on residential behavior. No evidence was offered to support these assertions. Beyond the fact that competing values and interpretations intrude at so many points, it is difficult for a court to assess the accuracy and evaluate the significance of such data in adversary proceedings—an important problem, not restricted, of course, to school segregation cases. Among the difficulties in this case were the following:

1. The lack of public disclosure constituted an obstacle to the fair evaluation of the data. Little of the testimony about recent school violations appeared in the newspapers during the course of the trial, so that people who had contrary information to that being presented were not aware of what was being reported to the courts. School principals with direct knowledge of how many children from their own schools were being bused to other schools did not know the exact nature of testimony given about busing until long after the ruling.[39] Some still do not know.

2. Public relations considerations played such a large part in the testimony of school board staff members that the free flow of information was inhibited. Most scholars minimize the power of site-selection to alter the pattern of racial imbalance in large cities with substantial black populations.[40] But the assertion that site-selection was a powerful influence was scarcely challenged directly—mainly, one guesses, because the Detroit board was officially committed to a platitudinous policy on this subject, originated by the state board of education. Nobody was willing to say publicly what most said privately: that the policy was virtually meaningless and, for the City of Detroit, incapable of contributing to the aim of promoting integration from the time it was adopted.[41]

3. The commitment to racial integration on the part of the leadership of the school system was such that testimony on school practices was marked by some lack of candor, distinct from public-relations considerations. I refer to a seeming reluctance to make statements which might weaken the fragile support of existing public opinion for the cherished goal of integration. In this broad sense, the two sides in the Detroit case were not adversaries.

IN the course of these several thousand pages there were many disputes and explanations (some brief, some lengthy) concerning

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various techniques and methods of research: the validity and adequacy of sampling procedures and questionnaire results; the use of census data to make inferences about school populations; the meaning of sampling error; the difference between cross-sectional and longitudinal analysis; the statistical significance of differences in samples and differences in total-enumeration procedures; the identification of variables as dependent or independent; the problems of regression-analysis; the ascertainment of item-reliability in an index; the appropriate indices for the measurement of socio-economic status; the association of variables and the correlation-versus-causation distinction; the selection and use of polar categories; the problems of demographic prediction and trend-extrapolation; the meaning of the scattergram; the standard error and cultural bias in testing; the computation of indices of segregation in schools and in housing; the meaning of the normal curve; the interpretation of scale differences; and, finally, the meaning and use of the chi-square test.

Some of these controversies and explanations illustrate the problems faced by courts in cases where scientific materials are offered. There were some explanations which required a fair amount of knowledge of quantitative techniques—which, as it appears from the record, some of those present, including the judge, did not have. (Here, as in the substantive areas, there was enormous advantage on the side of the plaintiffs, whose counsel had been specializing in school-segregation cases for years and had the help of academic consultants well acquainted with the professional literature.)

The layman's problems in following technical discussions of quantitative research procedures were only a minor obstacle to the court's understanding, however. The truly serious problem was the failure of the experts to convey to the judge the basic logic of scientific inquiry. In a recent article on the use of scientific experts in a product-liability case the authors concluded:

> . . . the presentation of evidence was such that this most significant question of . . . causation, pivotal to the litigation on any premise, was dispersed and never clearly and coherently addressed in the lengthy trial. Irrelevancies dominated, and the treatment of this major . . . issue was sporadic and shallow. . . . The analogy to the blind leading the blind is not inappropriate.[42]

This is what happened in Detroit, although there was more than one issue of causation involved. For example: There were lengthy statistical presentations on educational-resource allocations to predominantly black and white schools presented along with school achievement levels, but no explanation of how to discover what causal relationship, if any, exists between variations in school-inputs and variations in learning. Indeed, during the remedy hearings (after the trial ended) the judge revealed that he had thought all along that the child's socio-economic status was "part of input"![43] What had he made of all those discussions about resources and social class? It seems clear that much of the significance of this key

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causal controversy somehow escaped him, yet his intelligence and conscientious interest are clear from the record.

A second key causal controversy centered around the impact of racial concentration on achievement; and again, graphic presentations showing school achievement levels and school racial composition were offered. But since academic achievement scores are not disaggregated by race in Detroit there is no way even to begin to study the "effects" of the variations in school racial composition. In all of the hundreds of pages of testimony on the "effects" of a variety of factors on Detroit's black students, the absence of data classified by race within schools was not discussed, nor the implications of this deficiency explained to the judge.[44]

In some instances issues of central importance vanished during elaborate presentations which had the form, but not the substance, of "social science." For example, in the presentation of various calculations of the proper social-class mix for desegregation plans, white children were collapsed into polar categories: They were either "middle-class" (often described as "high-status") or "poor" whites—and the white working class virtually disappeared from one of the world's great industrial centers. Much of the testimony on educational topics was not far above the level of "pop" sociology. Terms were not clearly defined nor consistently used. Anecdotal material was offered, without challenge, to establish general propositions. Hypotheses—concerning, e.g., the "tipping point"—were presented as if they were verified generalizations. Sources were sometimes cited incorrectly;[45] some "facts" were inaccurate;[46] some accounts of research were garbled.[47] (Several important references to data in the Coleman report, for example, were erroneous or distorted.[48])

WHAT is the appropriate role for social science in the courtroom? The growing reluctance to use research findings and scholarly opinion as grounds for desegregation orders seems a proper recognition of the "revisionist" character of scientific knowledge. (Some of the most important reanalyses of the data used in the study by Coleman *et al.*, as well as other research on the effects of pupil heterogeneity on achievement, for example, appeared *after* the Detroit trial.) In the future new knowledge may support, question, or reverse earlier findings. Social-science testimony performs a useful and necessary function when, as Michael Katz has noted, such material reveals erroneous assumptions and conclusions by "disclosing the inadequacies or insufficiencies in method, looseness in reasoning, or paucity of evidence relied upon to construct the causal model upon which a policy rests."[49] The removal of these insubstantial foundations should compel greater judicial reliance upon clear constitutional principles.

Regardless of the extent to which the social-science evidence offered in a desegregation case is used as legal underpinning for the court's decision, such material appears to have an important influence upon the general perspective of judges. Many pages of the

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transcript in the Detroit case read like a one-student-seminar session. The expert-witness/teacher instructs and explains; the judge/student asks a question, and verifies his understanding by a comment or example; the teacher then assesses and indicates (much too timidly) the accuracy of his pupil's understanding. But there are many aspects of courtroom procedural tradition which are educationally disadvantageous: the long time lapse between opposing witnesses testifying on the same topic; the absence of direct confrontation between experts who offer contradictory evidence, especially concerning the nature of factual material; the extreme deference shown to the court's remarks, which allows half-truths to stand uncorrected; the extent to which the adversary system controls the production of evidence; and the extent to which the emergence of the best approximation of scientific "truth" is jeopardized (just as in criminal cases) when the two sides are very unequal in expertise and experience. The court is a poor classroom. It is the only place where we can decide if a man is guilty of murder, but it is not a good place to study the causes of homicide. The source of some of these problems is in the very nature of the adversary system, and this raises the question whether matters of educational policy are appropriately handled by judicial proceedings.[50]

The adversary mode in the presentation of evidence always tends to offend our most basic notions of scientific inquiry. Barrington Moore has observed:

> If a defense lawyer is suddenly surprised by a piece of evidence as an argument turned up by the prosecution he is never supposed to say: "My, I had never thought of that! It's a good point and my client must be guilty." On the other hand, that is exactly what an intellectually honest scholar is supposed to do under the circumstances.[51]

The law literature contains many procedural suggestions aimed at modifying some of those aspects of adversary proceedings that most academic witnesses find so distasteful. Among these suggestions are proposals for court-appointed masters to evaluate evidence, panels of consultants, joint committees of legal and behavioral-science scholars to prepare written submissions and other materials, and "devil's advocates" (a title peculiarly appropriate for these school-segregation cases) to argue unpopular positions. No single reform would be more helpful than to make trial records readily available. Their inaccessibility is a serious problem for scholars, and a barrier to citizen review. The cost per page varies from $.50 to $1.50, making a copy of a lengthy trial record virtually unobtainable.

Social-science testimony *is* being used in these school cases, and it should be of better quality than much that was offered during the Detroit case. (A reading of some other rulings makes me suspect that this case was not unique.) Most academics are quite unaware of the level of some of the scientific evidence offered in such cases. How could they know? Media coverage of the testimony during the landmark Detroit case was surprisingly sparse. It might be useful

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for the professional societies of the academic disciplines involved to monitor trials on important social issues.

Perhaps it is because so many scholars shun adversary proceedings that some of the expert witnesses are not very expert. The professional societies would do well to develop lists of highly qualified people in various fields and to support strongly those willing to undergo the rigors of courtroom appearances—especially on behalf of those litigants willing to have the expert witness present as much of the "whole truth" as he thinks he knows at the time. The "whole truth," of course, will actually be only partial, and it will be tentative—and it is always subject to change.

* * *

Judge Stephen Roth died shortly before the Supreme Court ruled against the 53-district desegregation plan. The case was assigned to Judge Robert DeMascio who, with his three court-appointed "masters" and the school board, was required to remedy the *de jure* segregation found to exist in Detroit's schools, now under 25 per cent white. The NAACP reportedly plans new legal action involving a number of suburban school districts.

FOOTNOTES

[1] There is a voluminous literature on the subject from the field of law, and somewhat less from the social sciences. Examples from the former include: David Kirp and Mark G. Yudof, *Educational Policy and the Law* (Berkeley, McCutchan, 1974); Stuart S. Nagel, "Law and the Social Sciences: What Can Social Science Contribute?" *American Bar Association Journal*, Vol. 51 (1965); Howard L. Korn, "Law, Fact, and Science in the Courts," *Columbia Law Review*, Vol. 66 (1966); A. Kaplan, "Behavioral Science and the Law," *Case Western Reserve Law Review*, Vol. 19 (1967); Harry Kalven, "The Quest for the Middle Range: Empirical Inquiry and Legal Policy," in Geoffrey C. Hazard, Jr., ed., *Law in a Changing America* (Englewood Cliffs, Prentice-Hall, 1968); and several sections in Harold Horowitz and Kenneth L. Karst, *Law, Lawyers, and Social Change* (Indianapolis, Bobbs-Merrill, 1969). On the Northern school cases, Frank Goodman's "De Facto School Segregation: A Constitutional and Empirical Analysis," *California Law Review*, Vol. 60, No. 2 (March 1972), is an outstanding contribution. Among the contributions from the social sciences: Walter Berns, "The Law and Behavioral Science," *Law and Contemporary Problems*, Vol. 28 (1963); Alfred H. Kelly, "Clio and the Court: An Illicit Love Affair," in Philip B. Kurland, ed., *The Supreme Court Review* (Chicago, University of Chicago Press, 1956); I. A. Newby, *Challenge to the Courts: Social Scientists and the Defense of Segregation* (Baton Rouge, Louisiana State University Press, 1969); Arnold Rose, "The Social Scientist as an Expert Witness in Court Cases," in Paul F. Lazarsfeld *et al.*, eds., *The Uses of Sociology* (New York, Basic Books, 1967); Eleanor P. Wolf, "Civil Rights and Social Science Data," *Race*, Vol. XIV, No. 2 (October 1972); and Paul Rosen, *The Supreme Court and Social Science* (Urbana, University of Illinois Press, 1972).

[2] *Bradley vs. Milliken*, 338 *Federal Supplement* (Eastern District, Michigan, 1971).

[3] *Id.* at 585.

[4] *Id.* at 587.

[5] For example: Eunice and George Grier, "Obstacles to Desegregation in America's Urban Areas," *Race*, Vol. VI, No. 1 (1964); Anthony Pascal, *Economics of Housing Discrimination*, Rand Corp. (1967); Raymond Zelder, "Racial Segregation in Urban Housing Markets," *Journal of Regional Science*, Vol. 10, No. 1 (1970); Chester Rapkin and William Grigsby, *The Demand for Housing in*

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Racially Mixed Areas (Berkeley, University of California Press, 1960); Herbert Gans, "The Future of the Suburbs," in Charles M. Haar, ed., *The End of Innocence* (New York, Scott Foresman, 1972), pp. 84, 90-92.

[6] There was a marked disjunction in the testimony on this issue: The housing experts tended to minimize the existence and influence of the skewed social-class distribution of blacks, while much of the education testimony relied upon it as the chief explanation for the under-achievement of black students. The judge, however, seemed unaware of this discrepancy.

[7] Examples of this emphasis include Herbert Gans, *People and Plans* (New York, Basic Books, 1968), summarized on p. 282; Anthony Downs, *Urban Problems and Prospects* (Chicago, Markham, 1970), especially pp. 34-35; Eleanor P. Wolf and Charles N. Lebeaux, *Change and Renewal in an Urban Community* (New York, Praeger, 1969).

[8] When the judge asked whether there is "such a thing as an Afro-American culture," saying he "had the impression that most black people think there is," the response elicited from the chief housing witness, Karl Taeuber, was essentially negative (*Bradley vs. Milliken*, Trial Record pp. 394-396). For a variety of divergent views, see Robert Blauner, "Black Culture: Myth or Reality?" in Peter Rose, ed., *Americans from Africa*, Vol. 2 (Chicago, Aldine-Atherton, 1970); Lester Singer, "Ethno-gensis and Negro-Americans Today," *Social Research*, Vol. 29 (Winter 1962); Paul Metzger, "American Sociology and Black Assimilation," *American Journal of Sociology*, Vol. 76, No. 4 (1971); Gerald D. Suttles, *The Social Order of the Slum* (Chicago, University of Chicago Press, 1968), p. 136; Charles Keil, *Urban Blues* (Chicago, University of Chicago Press, 1966); and Hylan Lewis, *The Blackways of Kent* (Chapel Hill, University of North Carolina Press, 1955). Much scholarly work now recognizes the existence of some distinctive black social patterns, or "life styles," while avoiding the semantic and theoretical controversies surrounding the "black culture" concept. During the trial, only Lawrence Doss alluded (briefly) to that concept (*Bradley vs. Milliken*, T. R. pp. 4421-22).

[9] Henry Aaron has pointed out in *Shelter and Subsidies* (Washington, Brookings Institution, 1972) that if all non-blacks exercise their preferences for "own-group majority" living situations, segregation occurs without discrimination (p. 17). Many studies show the persistence of social relationships and "clustering" among a variety of white ethnics: e.g., Nathan Kantrowitz, *Ethnic and Racial Segregation in the New York Metropolis* (New York, Praeger, 1973); Erich Rosenthal, "Acculturation Without Assimilation," *American Journal of Sociology*, Vol. 67 (1962). A general theory is offered in Milton Gordon, *Assimilation in American Life* (London, Oxford University Press, 1964). The durability of black social ties and the tendency to "cluster," even in the absence of exclusion, has been noted by Philip Hauser, "Demographic Factors in the Integration of the Negro," in Talcott Parsons and Kenneth Clark, eds., *The Negro American* (Boston, Beacon Press, 1966), p. 96; L. G. Watts, H. E. Freeman, H. M. Hughes, R. Morris, and T. F. Pettigrew, *The Middle Income Negro Family Faces Urban Renewal*, Brandeis University (1964), especially pp. 94-95; and Norman M. Bradburn *et al.*, *Side by Side* (New York, Quadrangle, 1971), pp. 133-134.

[10] Alternative explanations which stress the failure of transition areas to attract sufficient numbers of new white residents include Harvey L. Molotch, *Managed Integration* (Berkeley, University of California Press, 1972), and Wolf and Lebeaux, *op. cit.;* evidence questioning high residential mobility by whites as a "cause" of transition has been found by a number of investigators—e.g., Avery M. Guest and James J. Zuiches, "Another Look at Residential Turnover in Urban Neighborhoods," *American Journal of Sociology*, Vol. 77, No. 3 (November 1971). The absence of evidence for the "tipping point" hypothesis (freely utilized in testimony during the trial and remedy hearings) is noted in Eleanor Wolf, "The Tipping Point in Racially Changing Neighborhoods," in Bernard Frieden and Robert Morris, eds., *Urban Planning and Social Policy* (New York, Basic Books, 1968) and in Arthur L. Stinchcombe, Mary McDill, and Dollie Walker, "Is There a Racial Tipping Point in Changing Schools?" *Journal of Social Issues*, Vol. 25, No. 1 (1969).

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[11] The questionable empirical basis for this assumption is ably presented by John W. Hanley, Jr., "*Keyes vs. School District No. 1:* Unlocking the Northern Schoolhouse Door," *Harvard Civil Rights-Civil Liberties Law Review*, Vol. 9, No. 1 (January 1974), pp. 130-131, and footnote No. 38. For an example of sociological research which might have been cited to dispute it, see Leonard Blumberg and Michael Lalli, "Little Ghettoes: A Study of Negroes in Suburbia," *Phylon*, Vol. 27, No. 2 (1966). Karl Taeuber, NAACP's housing witness in *Negroes in Cities* (Chicago, Aldine, 1965), contends that housing segregation exists "... regardless of ... local laws and policies ... and other forms of segregation or discrimination" (pp. 35-36), but this was not said at the trial.
[12] *Bradley vs. Milliken*, 338 F. Supp. (E. D. Mich. 1971) at 593.
[13] *Bradley vs. Milliken*, 484 F. 2d (6th Circuit, 1973) at 242.
[14] *Bradley vs. Milliken*, 338 F. Supp. (E. D. Mich. 1971) at 586, 587.
[15] *Id.* at 585.
[16] *Bradley vs. Milliken*, 418 (U.S. 1974), Justice White, dissenting, p. 18, Slip Opinion.
[17] Studies which might have been cited include: Nathan Glazer and Daniel P. Moynihan, *Beyond the Melting Pot* (Cambridge, M.I.T. Press, 1970); Morris Gross, *Learning Readiness in Two Jewish Groups*, Center for Urban Education (1967); Gerald Lesser, Gordon Fifer, and Donald H. Clark, *Mental Abilities of Children from Different Social Classes and Cultural Groups*, Monographs of the Society for Research in Child Development, Vol. 30, No. 4 (1965); Kevin Marjoribanks, "Ethnic and Environmental Influences on Mental Abilities," *American Journal of Sociology*, Vol. 78, No. 2 (September 1972); A. J. Schwartz, "The Culturally Advantaged: A Study of Japanese-American Pupils," in Edgar Epps, ed., *Race Relations* (Cambridge, Winthrop, 1973). Historical sources showing differential school achievement of various white ethnics are cited by Colin Greer, "Immigrants and School Performance," in *The Great School Legend* (New York, Basic Books, 1972); and by Diane Ravitch, *The Great School Wars* (New York, Basic Books, 1974), summarized on p. 311.
[18] *Bradley vs. Milliken*, T. R. pp. 874-876.
[19] A summary of 50 studies of the effects of "tracking" published by the National Education Association (1968), reveals inconsistent and inconclusive findings. Glen Heathers, summarizing an array of research on "grouping" in the *Encyclopedia of Educational Research*, 4th edition, American Education Research Association (New York, Macmillan, 1969), found "no consistent effects" (p. 565). Among the most comprehensive studies is *Ability Grouping in the Public School*, Dembar Educational Research Services, Inc. (1966) by Walter Borg, who concludes that his findings question the "dire consequences ... predicted by critics of ability grouping" (p. 92). A later analysis by Miriam M. Bryan, *Ability Grouping: Status, Impact, and Alternatives*, ERIC Clearinghouse (June 1971), notes that the evidence on the impact upon achievement is "conflicting." Christopher Jencks *et al.*, in *Inequality* (New York, Basic Books, 1972), conclude after surveying research findings that "if tracking affects test scores at all, the effect is too small to be pedagogically significant" (p. 107); see also p. 34 and p. 96.
[20] The only research cited in support of these assertions was Robert Rosenthal and Lenore Jacobson, *Pygmalion in the Classroom* (New York, Holt, Rinehart and Winston, 1968). Severe critical appraisals of this work have been made by a number of scholars, including William L. Claiborn, in "Expectancy Effects in the Classroom: A Failure to Replicate," *Journal of Educational Psychology*, Vol. 60, No. 5 (1969); Richard E. Snow, in "Unfinished Pygmalion," *Contemporary Psychology*, Vol. XIV, No. 4 (April 1969); Robert Thorndike, in "Review of *Pygmalion in the Classroom*," *American Educational Research Journal*, Vol. 5, No. 4 (November 1968); and Elyse S. Fleming and Ralph G. Anttonen, in *American Educational Research Journal*, Vol. 8, No. 2 (1971), who noted that the work "had a far-reaching effect on educators, many of whom have accepted the findings unquestioningly" (p. 241).
[21] See Leonard Fein, *The Ecology of the Public Schools* (Indianapolis, Pegasus, 1971). See also Alan A. Altshuler, *Community Control* (Indianapolis, Pegasus, 1970). William Grant, in "Community Control vs. Integration—the Case of

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Detroit," *The Public Interest,* No. 24 (Summer 1971), stated: "The issue was simply whether, as a practical matter, community control is compatible with racial integration. And the unequivocal answer in Detroit was no" (p. 62). A single witness, Lawrence Doss, acknowledged this problem but appeared unfamiliar with the academic literature that supported his views (*Bradley vs. Milliken,* T. R. pp. 4392-93, 4400-1).

[22] For example: Defense expert contended that if (low socio-economic status) black children "are placed in classrooms where the socio-economic status of the white children is middle or above, the performance of the black children is increased . . . (the white proportion) would have to be 51 per cent or more, and probably the higher one goes above that the better. . . " (*Bradley vs. Milliken,* T. R. p. 4126A). Plaintiffs' expert stated that the disparity in black-white achievement becomes minimal the gap closes as schools are made more multiracial (Bradley vs. Milliken, T. R. pp. 1008, 1059). During the remedy hearings the "accelerated impact" on black achievement was described as a "logarithmic curve" (Metropolitan Remedy hearings, p. 1419). It has been widely noted that cross-sectional data do not permit this inference of causality: "There is nothing whatever in the Coleman analysis that can justify such an inference. The Coleman study contains no data at all on the effects that might accrue from 'putting' minority pupils with different kinds of schoolmates." See Henry S. Dyer, "School Factors and Equal Educational Opportunity," *Harvard Education Review,* Vol. 38, No. 1 (1968), p. 53. In "Equality of Educational Opportunity: Reply to Bowles and Levin," *Journal of Human Resources,* Vol. III, No. 2 (1968), Coleman agreed that his "report does not prove the effect of the student body's social composition"; and he had warned, in a 1967 article, "Toward Open Schools," *The Public Interest,* No. 9 (Fall 1967), that the 50 per cent inference was "mistaken" (p. 22).

Questions of causality aside, the weight of scholarly evidence is that peer effects on scholastic achievement, compared with the impact of the individual student's own social background, are rather slight. Early on, Coleman characterized the benefits of integration to achievement as "only a *small step* toward equality" (my emphasis, *ibid.,* p. 23). Gerald Grant in his review-essay of Frederick Mosteller and Daniel P. Moynihan, eds., *On Equality of Educational Opportunity,* in *Harvard Education Review,* Vol. 42, No. 1 (1972), stated: "It is highly *uncertain at this point what school policies, if any,* can compensate for the inequalities in cognitive skills between rich and poor children that are apparent at the time they enter school" (p. 110, emphasis mine). See also Jencks, *op. cit.* Nancy St. John had concluded in 1970 that findings on the impact of racial mix were inconclusive in "Desegregation and Minority Group Performance," *Review of Educational Research,* Vol. 40, No. 1 (February 1970). Judge Roth heard no expert testimony during the trial which incorporated any of these warnings.

[23] For example, defendants' expert witness, *Bradley vs. Milliken,* T. R. pp. 4209-12.

[24] An example is Kenneth Clark, "Social Policy, Power, and Social Science Research," in *Perspectives on Inequality,* Reprint No. 8, *Harvard Education Review* (1973). See also *New York Times* (June 11, 1972).

[25] Paul Dimond, "School Segregation in the North: There Is But One Constitution," *Harvard Civil Rights-Civil Liberties Law Review,* Vol. 7, No. 1 (January 1972), p. 46. Almost simultaneously, James S. Coleman warned the courts about the use of evidence from the Coleman report as a basis for decisions about educational inequality. See "Coleman on the Coleman Report," *The Educational Researcher,* Vol. I (March 1972), pp. 13-14.

[26] See William Grant, *op. cit.,* for background information on the pro-integration orientation of the leadership of the Detroit school system.

[27] A principal (and constantly cited) hypothesis underlying the plans and the ruling for a metropolitan desegregation remedy was that stable integration was neither possible nor beneficial if the proportion of black pupils (predominantly poor) was much over 30 per cent. However, the Detroit public schools had not had so small a percentage since before the *Brown* decision, according to our best estimates; no racial count was taken until 1961, when the system was

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almost 46 per cent black. By 1972 it was approximately two thirds black.
[28] A recent book has erroneously identified him as black; others have assumed (also erroneously) that he was Jewish.
[29] On April 7, 1970, the pro-integration majority of the Detroit Board of Education announced a plan to alter the attendance boundaries of several high school districts to improve their racial balance. About half of approximately 9,000 students affected were white; they would henceforth go to predominantly black schools. This move was apparently an attempt to head off a threat of increased racial separation as a consequence of the newly enacted, but not yet implemented, decentralization act passed by the Michigan legislature the previous year. The legislature responded by enactment of a law (Act 48) which had the effect of overturning the "April 7 plan," and large segments of the public responded by a swift and successful recall campaign to unseat the pro-integration board members. Action by the NAACP to have the crucial portion of Act 48 declared unconstitutional succeeded (October 13, 1970), but Judge Roth rejected a plea to reinstitute the "April 7 plan," selecting the "magnet plan" instead. The NAACP then charged the board and the state with operating a segregated school system. Judge Roth began hearing the case April 6, 1971.
[30] Ruling of December 3, 1970.
[31] Colloquy with counsel, October 4, 1971.
[32] *Bradley vs. Milliken,* 338 F. Supp. (E. D. Mich. 1971) at 592.
[33] Owen Fiss, "The Charlotte-Mecklenburg Case—Its Significance for Northern School Desegregation," *University of Chicago Law Review,* Vol. 38, No. 4 (1971).
[34] *Ibid.,* p. 705.
[35] See Wolf and Lebeaux, *op. cit.,* Parts I, II, VI; also Wolf and Lebeaux, "Class and Race in the Changing City," in Leo Schnore and Henry Fagin, eds., *Urban Research and Policy Planning* (New York, Russell Sage, 1967), pp. 107-11, 124-28.
[36] The exigencies of court procedure cause a long lapse to occur between the testimony—e.g., concerning a specific school violation—presented by the plaintiffs' expert witness and the sometimes contradictory testimony presented by the defendants' expert witness. With so much intervening time and additional material, it is hard to remember all of the particulars.
[37] The Detroit Board did not appeal the finding of *de jure* school segregation to the Supreme Court.
[38] By 1965, all but one of these "zones" had been abolished, making a study of their alleged impact very difficult. Research support for the general impact of any of these practices is weak or absent: "The racial composition of city schools is becoming more homogeneously Negro. . . . Whether or not the pattern of segregated schools changes, simply because the relative number of Negroes increases" [Karl Taeuber, *Hearings of the Senate Select Committee on Equal Educational Opportunity,* Part 5 (August 25, 1970), p. 2731]. The NAACP now often defines "segregated" as "racially identifiable"—i.e., appreciably different from the overall racial proportions of a school district. (For reasons too complex to discuss here, the term "racially imbalanced" is avoided.)
[39] The names of these schools were not disclosed in the District Court's ruling.
[40] I find no research support for the testimony of Gordon Foster (the plaintiffs' expert on desegregation) that the "community perceptions" which arose as a result of site-selections exerted some important—but unspecified—influence. See *Bradley vs. Milliken,* 484 F. 2d (6th Circuit, 1973) at 237, 238. Thomas Pettigrew described site-selection and other such strategies (short of educational parks) as "Band-Aids" in systems with large proportions of blacks. See "The Negro and Education," in Irwin Katz and Patricia Gurin, eds., *Race and the Social Sciences* (New York, Basic Books, 1969), p. 95.
[41] *Bradley vs. Milliken,* T.R. pp. 2052-2053. By 1966, when the state board of education directed school systems to avoid, as far as possible, racial segregation in school site selection, Detroit's public school population was almost 57 per cent black (see footnote 27, above) and almost all mixed areas experienced racial succession.
[42] Henry R. Piehler *et al.,* "Product Liability and the Technical Expert," *Science*

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(December 20, 1974), p. 1091.

[43] Metropolitan Remedy hearings, pp. 111-116.

[44] The presentation by David Armor, reporting research on the outcome of some "busing programs," did identify central methodological problems in studying integration effects, but his deposition was taken on the initiative of suburban counsel during the remedy hearings, long after the trial ended, and was ruled inadmissible by the court. See David Armor, "The Evidence on Busing," *The Public Interest,* No. 28 (Summer 1972), pp. 90-126; and David Armor, James Q. Wilson, Thomas Pettigrew *et al.*, "On Busing: an Exchange," *The Public Interest,* No. 30 (Winter 1973), pp. 88-134.

[45] For example, *Bradley vs. Milliken,* T.R. pp. 874-75, 914, 963-64; and Metropolitan Remedy hearings, p. 98.

[46] The population statistics cited in the District Court's ruling were assigned to a demographer for analysis. Dr. Stanley Kupinsky reported inaccuracies in the median age cited for whites, in the percentage of blacks for 1920, in references to the numbers of blacks of child-bearing age, and in the percentages of blacks and whites in various other age groupings. For examples of other factual errors, *Bradley vs. Milliken,* T.R. pp. 877-78, 933, 947, 963; Detroit Remedy hearings, pp. 575-77.

[47] For example, *Bradley vs. Milliken,* T.R. pp. 891-93, 960, 1008, 4122, Detroit Remedy hearings, p. 508.

[48] For example, *Bradley vs. Milliken,* TR. p. 987; Detroit Remedy hearings, p. 521; Metropolitan Remedy hearings, pp. 46-48, 97-98, 221.

[49] Michael Katz, "The Unmasking of Dishonest Pretensions: Toward an Interpretation of the Role of Social Science in Constitutional Litigation," *The American Sociologist,* Vol. 6 (June 1971), pp. 55-56.

[50] See Nathan Glazer, "Towards an Imperial Judiciary?" *The Public Interest,* No. 41 (Fall 1975), pp. 104-124.

[51] Barrington Moore, *Reflections on the Causes of Human Misery* (Boston, Beacon Press, 1972), pp. 95-96.

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CURRENT READING

Expenditure Loopholes

A great deal of discussion and indignation has been devoted to the subject of "tax loopholes," legal provisions that are taken advantage of by individuals or corporations to avoid payment of some portion of their federal taxes. But a new Brookings Institution study by Martha Derthick looks at the opposite side of the coin—"expenditure loopholes," through which far greater sums may be obtained from the federal treasury than was ever contemplated by either Congress or the executive. Miss Derthick's study, *Uncontrollable Spending for Social Services Grants,* is summarized in the Summer/Fall 1975 issue of the *Brookings Bulletin:*

> That the federal budget is out of control has become a commonplace. The Office of Management and Budget declared in its budget proposals for fiscal 1975 that 73.5 per cent of federal spending in that year would be "relatively uncontrollable," meaning that the government's obligations were fixed by acts of Congress. In practice, however, responsibility for spending is shared between the executive and legislative branches; if spending is out of control, responsibility for that is shared, too. Martha Derthick, a senior fellow in Governmental Studies, examines a program in which executive control of spending was conspicuously lacking for several years: grants-in-aid to the states for social services under the public assistance titles of the Social Security Act, as amended in 1962.
>
> Social services grants are one of a large and growing array of efforts by the federal government to help the poor, the sick, and the handicapped by means of payments to lower levels of government. Spending for these grants soared from $354 million in fiscal 1969 to $1.69 billion in fiscal 1972, a more than fourfold increase. A private study found in 1972 that 25 per cent of this money went for child foster care and 15 per cent for child care, the rest being distributed among myriad activities such as special services for handicapped children, treating alcoholism and drug addiction, and caring for the mentally ill and retarded. But exactly what it was spent for, no one knows—and that is part of the story.
>
> Social services grants were "uncontrollable" because they were open-ended. The law put no ceiling on the amount that could be spent, while obligating the federal government to match whatever the state

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governments spent for social services. Congress eventually closed the open end with a $2.5 billion ceiling imposed in 1972, but only after social services grants had turned into a runaway giveaway.

What made this program remarkable, Derthick says, was neither its size nor its exceptional growth rate, but the fact that neither the size nor the growth was intended by the Congress or the chief executive. The President's budget estimate of $937 million for services grants in 1972 was too low by nearly a billion dollars. In the House of Representatives, Chairman Wilbur Mills of the Ways and Means Committee denounced social services grants as "the worst loophole that has ever been written into the law on the financing of government."

Then how could this "accident" happen? The Office of Management and Budget has procedures to safeguard the President against this kind of surprise and to preserve a range of budgetary choices for him. Where did the procedures fail? For spending on social services to explode during a Republican administration would seem inexplicable unless the bureaucracy sabotaged the administration's intent. Such an explanation would fit much current theory about the power of professional bureaucracies, Derthick says, but it doesn't fit the facts of the case.

A loose law, a fundamental change in the way services grants were administered in Washington, rising demand for federal benefits, greater federal responsiveness to the states—all these conditions made the spending surge probable. It remained for the states to discover the loophole and exploit it. California led the way, followed by Illinois, whose welfare department touched off a spending explosion in 1972 by eliciting from the Department of Health, Education, and Welfare a new and elastic statement of federal policy governing payments for social services. In effect, Illinois covered its prospective budget deficit in that year with federal funds. Then an informal meeting of state governors estimated that state requests for grants for fiscal year 1973 would total $4.7 billion. Nine states projected increases of more than 1,000 per cent over the grants in 1971, with Mississippi projecting an increase that would account for more than half its budget.

In the end the states killed the golden goose by asking too much. Congress closed the loophole when its exploitation became absurd. In establishing general revenue sharing under the State and Local Fiscal Assistance Act of 1972, Congress also imposed the $2.5 billion annual ceiling on social services grants and limited each state's share to its percentage of the national population.

The lessons? First, Derthick says, the federal government should never pledge itself to pay unlimited sums to state governments for purposes so broad as to be nearly meaningless. Had the purpose of these grants been clear, the lack of an expenditure ceiling wouldn't have mattered much; had expenditures been limited, the law's lack of purpose would have mattered less than it did. It was the combination —the joining of ill-defined intentions with an unlimited obligation— that created the "worst loophole." Social services grants resembled neither general revenue sharing, for which the law fixes a spending limit, nor most categorical grant programs, whose purposes are defined

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by statute. The plain lesson is that federal grant-in-aid laws should include one or the other constraint, or both.

Second, for all its defects, the law did not in fact obligate the Department of Health, Education, and Welfare to match anything the states might claim as social service expenditures. What the federal government had to spend depended, rather, on what HEW officials allowed the states to put into their plans. In that sense the law made the executive branch bear virtually the whole burden of expenditure control. Derthick concludes, however, that the loophole was not created by career bureaucrats who pulled the wool over the eyes of amateurs in the appointive policymaking positions in HEW. Rather, it was the political appointees who took initiatives or made choices that enabled the states to transform services grants into an uncontrolled source of fiscal relief.

Derthick contends that the President's budget staff failed to check HEW's policymakers because its commitment to fiscal control was declining, because it lacked the foresight and knowledge required for control, and because its opportunities to intervene were limited and intermittent. Nor does she find much evidence to support hope that OMB's capacity for control or review of departmental operations can be increased significantly.

Summing up this cautionary tale, Derthick suggests that would-be reformers of public administration in the American welfare state begin by looking at the quality of appointive officials, their conception of their duties, the pressures that come to bear on them, and the assets they need to perform their jobs. Those officials may well need protection against the professional specialists below; but if they need help with the technocracy, it remains equally true that they need the help of the technocracy against the politicians.

Campaign Reform—Second Thoughts in the Senate

Writing in the Fall 1974 issue of *The Public Interest* (No. 37), Marc F. Plattner examined the campaign reform legislation then under consideration in the Congress. Mr. Plattner called attention to some of the potential pitfalls and dangerous side effects of the legislation—considerations largely ignored in the post-Watergate fervor to "clean up the electoral process." The Federal Election Campaign Act of 1974 has now been on the books for only a little over a year, yet some of its most ardent supporters have already begun to voice grave doubts about what they have wrought. An article by David Broder in the Washington *Post* (October 19, 1975) recounts a striking change of heart on the part of Senators Pastore and Muskie:

> Sen. John O. Pastore, D-R.I., who has announced his retirement at the end of next year, is free to speak with notable candor. Pastore was a co-sponsor of the legislation and a member of the Senate-House conference committee which put it in its final form.

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And what does he think of it now? "The law is absurd. We created a monster. It is our own fault. . . . We have a law now that even the people who wrote it do not understand."

How can such a thing happen?

Here is Pastore's answer, on the Senate floor:

"I remember I went to that conference. We were there for days and days and days, and nobody understood what was in that bill. But at that time we were running like scared rats for some reason. I do not know why. We were running like scared rats. We thought the stronger we make it, the more the people would believe us. I do not think they believe us any more today than they did before we passed the law."

If that sounds like an epitaph for the spasm of post-Watergate morality that produced the campaign finance reform law, you are hearing it exactly right. . . .

As Sen. Edmund S. Muskie, D-Maine, said in a characteristically thoughtful comment on last week's controversy:

"I wish to make it clear that since the passage of the act last year, I have had increasing reservations about the constitutionality and the wisdom of fixing limits on the amount of money which any candidate for federal office can expend on his campaign.

"The right to communicate one's views to the voters, and the right of voters to make a choice among candidates based upon an informed judgment of what a candidate stands for, is basic to our democratic process. As a practical matter, exercising this right today requires access to expensive commercial communications media. Spending limits which restrict that access may, in my opinion, be inconsistent with the First Amendment freedoms embodied in the Constitution."

Muskie's view carries special weight because he had been a strong supporter of the law. . . .

Died of Extreme Accountability?

In the October/November 1975 issue of *Technology Review*, the distinguished economist Kenneth E. Boulding considers the dangers of an overzealous pursuit of the ideal of consumer protection:

There is evidence of an emphatic shift in the direction of the legal system here and in other countries from *caveat emptor*—let the buyer beware—to *caveat vendor*—let the seller beware. The change is subtle and has slipped in without much discussion. It could have important consequences. One sees it at work, for instance, in the spectacular increase in malpractice suits, in consumer legislation, in the great number of court decisions awarding damages to purchasers of defective products, in the environmental protection movement, and so on. One can sympathize with much of this: The trouble with *caveat emptor*, ultimately, is that the buyer tends to be more ignorant than the seller and is likely to fall victim to the seller's sins of commission. Because the buyer may not readily be able to detect defects in what he is buying, he needs protection by some kind of public regulation or organization. . . .

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There must be a point, however, at which the protection of the buyer is carried too far. Then the attempt to correct sins of commission leads to the producer's failure to do anything at all, simply because the costs of uncertainty and honest mistakes are unbearable.

Whether we have reached this point in our own society, I do not know—but I worry about it. I grew up in a culture that assumed that if something were wrong with you, it was your fault, and if not, it was somebody else's. The great virtue of this ethic is that one usually has a better chance of correcting one's own defects. We now seem to be assuming that if anything is wrong, it is most likely someone else's fault. This often has the disadvantage of leading to windy preaching and bellyaching rather than corrective action. Even when the assumption does lead to corrective action, however, there is grave danger of overdoing it. Perhaps we are close to, or even beyond, this critical point today.

It is, unfortunately, very hard in practice to distinguish between honest mistakes and deliberate evil. No one would deny that society should discourage deliberate evil—that's what law is mostly about. If, however, the sanctions against evil are too severe, they may be applied against honest mistakes, as well, to the point where nobody will be willing to do anything or take any risks. The problem is somewhat analogous to one in the theory of signal detection: if we try too hard to avoid "misses" (that is, not detecting the signal when it is there), we will cause too many "false alarms" (that is, detecting the signal when it isn't there). So it seems that we must tolerate a certain amount of evil in order to encourage people to take the inevitable risks involved in doing good.

If we had a law that anybody who drilled a dry oil well would be shot, very few wells would be drilled. Our tolerance of dry wells does not seem to extend to research projects, which are always expected to gush; to doctors, whose treatments must always cure; to teachers, who must never fail a student; and to manufacturers, who must never sell a defective product.

So it may be that the epitaph of our society will read: "Died of extreme accountability."

A Covey of Coups

Recent developments at the United Nations have brought home to the American people the fact that liberal democracies constitute a small and dwindling proportion of the world's regimes. A relatively unnoticed fact, however, is the dramatic increase in the number of nations that have military governments. S. E. Finer, writing in the August 7, 1975 issue of *New Society*, offers some striking statistics on this phenomenon:

> The military coups in Nigeria—not to speak of Greece, Chile, and Portugal—caught the western imagination and attracted wide comment; but the general increase in the number of military coups and of military regimes has not been so well publicized. I wrote a book on this

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subject, *The Man on Horseback*, in 1962. Since then, there have been 104 more coups affecting 35 more states. In 1962, the number of states ruled by governments which attained office as a result of a coup was, at most, 13; today there are no less than 42. This figure represents some 26 per cent of the total of sovereign states in the world. It is made up from over half the Latin American population, and some two thirds of the populations of North Africa, the Middle East, and sub-Saharan Africa. . . .

A statistical count confirms the public's general impression of military regimes: for whereas, in their economic performance, they are hardly distinguishable from the civilian ones, in their political style they are quite distinct. They differ from the civilian regimes in that nearly all curtail or abolish the constitutional guarantees, ban assemblies, ban the Communist Party and, to a lesser extent, all other parties as well; and they stuff the executive with military officers.

This might find defenders, if the military regime could claim that it made the future more certain, more predictable, and more stable for its citizens. But precisely the opposite happens. No less than 48 per cent of them last fewer than two years and only 21 per cent last longer than five years. Not only that; only about one eighth are brought down by the civilians (and one eighth are brought to an end by civilians and other military factions combined). But the vast bulk of regimes installed by the military—82 per cent—are brought down by the military. Altogether, this combination of coercive repression with shortlived governments (installed and removed by other military factions), together with the likelihood that the economic performance will be much the same as if the civilians had remained in office, seems a pretty poor option. But of course it is not the civilian populations who exercise this option. It is their armed forces that do it for them.

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